IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 544

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

—v.—

LINCOLN SAVINGS AND LOAN ASSOCIATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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TAX COURT OF THE UNITED STATES

Docket No. 325-67

LINCOLN SAVINGS AND LOAN ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DOCKET ENTRIES

Date	Filings and Proceedings
Jan. 16, 1967	PETITION FILED: FEE PAID Jan. 16, 1967; Served Jan. 17, 1967
Mar. 20, 1967	REQUEST by Resp. for trial at Los Angeles, Calif. Action, Granted 3/21/67; Served Mar. 23, 1967
Mar. 20, 1967	ANSWER filed by Resp. Served Mar. 23, 1967
Jan. 16, 1968	NOTICE of TRIAL April 8, 1968 at Los Angeles, Calif. Served Jan. 16, 1968
Mar. 4, 1968	MOTION by petr. for leave to file Amendment to Petition. Amendment to Petition Lodged. Action, Granted March 26, 1968; Served Mar. 27, 1968
March 6, 1968	NOTICE of filing of petr. motion for leave to file amendment to petition and hearing on March 27, 1968, if objection filed by March 22, 1968. Served March 6, 1968
March 26, 1968	Amendment to Petition filed; Served Mar. 27, 1968

Date	Filings and Proceedings
April 8, 9, 10, 1968	TRIAL before Judge Raum—Los Angeles, California
	Stipulation of Facts w/attached exhibits
	Respondent's Amended Answer filed and served
	PARTIES shall file with the Court exhibits #42, 44, 45 and 29AC.
	BRIEFS due May 27, 1968
	REPLY BRIEFS due June 26, 1968
	SUBMITTED TO JUDGE RAUM UNDER SUBMISSION
April 24, 1968	TRANSCRIPT of Trial of Apr. 9 & 10, 1968, rec'd (2).
April 29, 1968	TRANSCRIPT of Trial of Apr. 8, 1968, received.
May 27, 1968	BRIEF for Respondent filed; Served May 29, 1968
May 29, 1968	BRIEF for Petitioner filed (20-P); Served May 29, 1968
May 29, 1968	ENTRY OF APPEARANCE for petr. by Victor L. Walch; Served June 7, 1968
June 24, 1968	JOINT MOTION to extend time from June 26, 1968 to July 10, 1968 to file Reply Briefs. Action, Granted 6/25/68; Served Jun 26, 1968
June 26, 1968	MOTION by Cyrus A. Neuman for leave to file Amicus Curiae Brief. Action, Granted 6/26/68; Served Jun 27, 1968

Date	Filings and Proceedings
June 26, 1968	AMICUS CURIAE BRIEF filed by Cyrus A. Neuman. (Brief was served on both petr. and resp. by Cyrus A. Neuman.)
July 10, 1968	REPLY BRIEF for Respondent filed. Served July 11, 1968
July 11, 1968	REPLY BRIEF for Petitioner filed. (Permission to file); Action (20-P. copies); Served July 11, 1968
Oct. 21, 1968	FINDINGS OF FACT AND OPINION filed Judge Raum
	Decision will be entered for the respondent; Served Oct 21, 1968
Oct. 21, 1968	DECISION entered, Judge Raum. Served Oct. 21, 1968
	APPELLATE PROCEEDINGS
Jan. 13, 1969	NOTICE of Appeal to USCA, Ninth Cir., filed by petitioner. Served Jan. 14, 1969
Jan. 14, 1969	NOTICE with copy of notice of appeal sent to Lester R. Uretz, Chief Counsel. Served Jan. 14, 1969
Jan. 14, 1969	NOTICE, to parties, of assembling and date for transmission of record. Served Jan. 14, 1969
Jan. 24, 1969	MOTION filed by Resp. to withdraw Exs. 1-A, 2-B, & 3-C & substitute copies. Action, Granted 1/27/69; Served Jan. 27, 1969

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Docket No. 23923

[Caption Omitted]

RELEVANT DOCKET ENTRIES

Date	Filings and Proceedings
1969	
Feb. 25	FILED FEB. 20, 1969, CERTIFIED TYPED TRANSC. OF REC. (PLEADINGS, VOL I)
	FILED ORIG. REPTR. TRANSC. IN THREE VOLS (VOLS 2, 3, & 4 OF REC.)
	FILED ORIG. EXHIBITS IN RM. 219 * * *
	DOCKETED CAUSE & ENTERED APPEARANCES OF COUNSEL
	* * *
Oct. 10	Argued and submitted to E[Ely]-Hu[Hufstedler], CJJ & Thompson, DJ
	* * *
1970	
	Hufstedler, CJ dis.
Feb. 2	ORDERED OPINION (THOMPSON) FILED & JUDG. FILED & ENT.
" 2	Filed opinion. Decision of Tax Ct. rev.
" 2	Filed & ent. judgment
Feb. 16	Recvd. appellee motion for ext of time in which to file en banc petition for rehearing (panel)
Feb. 19	Filed order (E) extding time to 2/24 in which appellee may file petition for rehearing

Date	Filings and Proceedings
1970	
Feb. 20	FILED 25 OF APPELLEES PETITION FOR REHEARING EN BANC
Feb. 20	Recvd. prae & entered appearance of counsel for appellee-CIR
March 18	Filed order (E Hu & Thompson) denying petition for rehearing rejecting suggestion for rehearing en banc.
Apr. 6	ISSUED JUDGMENT TO CLERK OF DISTRICT COURT

* * * *

TAX COURT OF THE UNITED STATES

[Caption Omitted]

PETITION

(Filed January 16, 1967)

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency dated October 20, 1966 (Service symbols Form L-50, Code 411:90D: PWK), and as the basis of its case alleges as follows:

1. Petitioner is a corporation organized and existing under the laws of the State of California with its principal office at 630 West Sixth Street, Los Angeles, California 90017. The return for the period involved here was filed with the District Director of Internal Revenue at Los Angeles, California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on October 20, 1966.

3. The deficiency as determined by the Commissioner is in income tax for the calendar year 1963 in the sum of $461,454.38, of which approximately $458,971.17 is in dispute.

4. The determination of tax set forth in the notice of deficiency is based upon the following errors:

(a) The Commissioner erred in disallowing a portion of the federal insurance premium expense paid and deducted on petitioner's income tax return for the calendar year 1963, namely, the sum of $882,636.86 out of a total of $1,018,397.38 of federal insurance premium expense paid and claimed for the year 1963.

(b) The Commissioner erred in determining any deficiency in petitioner's income tax liability for the calendar year 1963 in excess of the sum of $2,483.21.

5. The facts upon which petitioner relies as the basis of this case are as follows:

(a) Petitioner is a stock corporation, organized and existing under the laws of the State of California, engaged in the savings and loan business.

(b) Petitioner is a member of the Federal Home Loan Bank system (referred to herein as "FHLB"). Such membership is a necessity from a competitive business standpoint in the savings and loan business. As a member of the FHLB system petitioner is required to insure the savings accounts of its depositors with the Federal Savings and Loan Insurance Corporation (referred to herein as "FSLIC"), in accordance with the laws enacted by Congress.

(c) The FSLIC was organized in 1934 to provide stability to the savings and loan industry through insurance of savings accounts. Prior to January 1, 1962 each insured member was required to pay to the FSLIC an annual premium of 1/12 of 1 percent of the total of its savings accounts and creditor obligations, for insurance by the FSLIC of its depositors' savings accounts. Such insurance premiums have created what is known as the primary reserve on the books of the FSLIC, and have consistently been deducted as ordinary and necessary business expenses in carrying on the savings and loan business. Petitioner paid such insurance premiums during the year 1963 in the sum of $135,760.52, and the deduction thereof has been allowed by the Commissioner in the notice of deficiency.

(d) On September 8, 1961, Congress enacted Public Law 87-210, which, among other provisions, amended Section 404 of the National Housing Act by adding subsections "(d)", "(e)", "(f)", and "(g)" to Section 404, effective January 1, 1962. The Act as amended requires each insured member to pay to the FSLIC annually an additional insurance premium equal to 2 percent of the net increase in all savings accounts of the insured member during the preceding calendar year less the amount, if any, of required additional investment in FHLB stock. The additional insurance premium is credited on the books of FSLIC to a so-called secondary reserve account. Petitioner paid such additional insurance premium during the taxable year 1963 in the sum of $882,636.86 and

deducted such sum on its return for that year as an ordinary and necessary business expense. The Commissioner has disallowed such deduction, with the explanation in the notice of deficiency that "you have failed to establish that you are entitled to deductions in excess of the amounts allowed."

(e) The additional insurance premium thus disallowed was an expense necessarily incurred by petitioner as a condition to its continuing to engage in the savings and loan business during the year 1963. It was an ordinary expense of carrying on such business. Such additional premium was therefore an allowable deduction as an ordinary and necessary business expense under Section 162 of the Internal Revenue Code. The Commissioner's proposed disallowance thereof is erroneous and illegal.

(f) Petitioner is informed and believes, and therefore alleges, that the payment of the additional insurance premium of the character involved here was required by Congress in order to strengthen the FSLIC, because, due to rapid growth of insured members, the ratio of the FSLIC's reserves to its potential liability had dropped and it was deemed necessary that its reserves be built up at a faster rate than was occurring under the Act prior to its amendment in 1961. From petitioner's standpoint there was and is no practical difference between the premium payment under the original Act and the additional insurance premium. Both were expenses incurred in carrying on its business, and neither resulted in the acquisition by petitioner of any asset having any ascertainable fair market value. Any possibility of the return to petitioner of any portion of the additional insurance premium was and is so remote, indefinite, and contingent as to be negligible.

(g) The deduction of the additional insurance premium should accordingly be allowed as claimed on petitioner's return for the taxable year 1963.

WHEREFORE, petitioner prays that this Court may try the case, determine that the Commissioner erred as alleged above, and grant such other and further relief as may be proper in the premises.

/s/ A Calder Mackay
A. CALDER MACKAY

/s/ Adam Y. Bennion
ADAM Y. BENNION

/s/ Richard N. Mackay
RICHARD N. MACKAY
523 West Sixth Street, Suite 828
Los Angeles, California 90014.
COUNSEL FOR PETITIONER

[Jurat Omitted]

TAX COURT OF THE UNITED STATES

[Caption Omitted]

ANSWER

(Filed March 20, 1967)

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits, denied and alleges as follows:

1 and 2. Admits the allegations of paragraphs 1 and 2 of the petition.

3. Admits that the deficiency as determined by the Commissioner is in income tax for the calendar year 1963 in the sum of $461,454.38 but denies the remaining allegations of paragraph 3 of the petition. Alleges that the entire deficiency is in dispute.

4. Denies the allegations of paragraph 4 of the petition and all subparagraphs thereunder.

5 (a). Admits the allegations of subparagraph (a) of paragraph 5 of the petition.

(b). Admits that petitioner is a member of the Federal Home Loan Bank system (referred to herein as "FHLB") and that as a member of the FHLB system petitioner is required to insure the savings accounts of its depositors with the Federal Savings and Loan Insurance Corporation (referred to herein as "FSLIC"), in accordance with the laws enacted by Congress. Denies the remaining allegations of subparagraph (b) of paragraph 5 of the petition.

(c). Admits the allegations of subparagraph (c) of paragraph 5 of the petition.

(d). Admits the allegations of subparagraph (d) of paragraph 5 of the petition except denies that the payments referred to as "additional insurance premiums" constituted insurance premiums during the taxable year 1963.

(e)-(g), inclusive. Denies the allegations of subparagraphs (e)-(g), inclusive, of paragraph 5 of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiency determined by the respondent be in all respects approved.

/s/ Lester R. Uretz/DPC
LESTER R. URETZ
Chief Counsel
Internal Revenue Service

OF COUNSEL:

MELVIN L. SERRS
Regional Counsel
JAMES A. THOMAS
Attorney
Internal Revenue Service

JAT/emb (C)

TAX COURT OF THE UNITED STATES

[Caption Omitted]

AMENDED ANSWER

(Filed March 9, 1968)

THE RESPONDENT, in answer to the petition and Amendment to Petition filed in the above-entitled case, admits, denies and alleges as follows:

1 and 2. Admits the allegations of paragraphs 1 and 2 of the petition.

3. Admits that the deficiency as determined by the Commissioner is in income tax for the calendar year 1963 in the sum of $461,454.38 but denies the remaining allegations of paragraph 3 of the petition. Alleges that the entitre deficiency is in dispute.

4. Denies the allegations of paragraph 4 of the petition and subparagraphs (b) and (c) thereunder; * * * *

* * * *

5 (a). Admits the allegations of subparagraph (a) of paragraph 5 of the petition.

5 (b). Admits that petitioner is a member of the Federal Home Loan Bank system. Denies the remaining allegations of subparagraph (b) of paragraph 5 of the petition.

(c). Admits the allegations of subparagraph (c) of paragraph 5 of the petition.

(d). Admits the allegations of subparagraph (d) of paragraph 5 of the petition except denies that the payments referred to as "additional insurance premiums" constituted insurance premiums during the taxable year 1963.

(e)-(g), inclusive. Denies the allegations of subparagraphs (e)-(g), inclusive, of paragraph 5 of the petition.

* * * *

6. Denies generally each and every allegation of the petition and amendment to petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiency determined by the respondent be in all respects approved.

/s/ Lester R. Uretz
LESTER R. URETZ
Chief Counsel
Internal Revenue Service

OF COUNSEL:

AARON S. RESNIK
Acting Regional Counsel

JAMES A. THOMAS
Attorney
Internal Revenue Service

TAX COURT OF THE UNITED STATES

[Caption Omitted]

STIPULATION OF FACTS

(Filed April 9, 1968)

It is hereby stipulated that, for the purpose of this case, unless otherwise provided, the following statements may be accepted as facts and the exhibits attached as true copies of the original documents; provided, however, that either party may object to the admission of such facts or exhibits or both on the grounds of materiality and relevancy; and that either party may introduce other and further evidence not inconsistent with the facts herein stipulated:

1. Lincoln Savings and Loan Association (hereinafter—"petitioner" or "Lincoln Savings") is a corporation organized and existing under the laws of the State of California, having been incorporated on February 6, 1925. Its name, originally Lincoln Building & Loan Association, was changed on August 5, 1943 to Lincoln Savings and Loan Association. At the date of the filing of the petition in the instant case, petitioner's principal office was located at 630 West Sixth Street, Los Angeles, California. Petitioner filed its tax returns for the calendar years 1962, 1963 and 1964 with the District Director of Internal Revenue at Los Angeles, California, copies of which are attached hereto and marked Exhibits 1-A, 2-B and 3-C, respectively.

2. All of petitioner's outstanding stock (consisting of 2,500 shares with a par value of $100.00 per share) has been owned since 1964 by First Lincoln Financial Corporation, which is a corporation organized under the laws of the State of California with its principal office in Los Angeles, California. During 1962 and 1963, First Lincoln Financial Corporation owned 98.88% of petitioner's outstanding stock. On December 31, 1963, First Lincoln Financial Corporation had 1,402,654 shares of stock outstanding, without par value, owned by approximately

2,800 shareholders. The stock of First Lincoln Financial Corporation is traded over-the-counter.

3. On February 6, 1925, petitioner was licensed as a savings and loan association by the Savings and Loan Commissioner of the State of California, and since that date at all times petitioner has been and remains a licensed savings and loan association under the laws of the State of California, transacting business in the Los Angeles area. California licensed savings and loan associations are regulated by Division II of the California Financial Code (West's Annotated California Codes, Financial Code, Section 5,000, et seq.), and by regulations of the California Savings and Loan Commissioner, being Chapter 2 of Chapter 10 of the California Administrative Codes, which law and regulations are incorporated herein by reference. Attached hereto and marked Exhibit 4-D is a copy of a letter dated December 4, 1962, by the California Savings and Loan Commissioner issued to all California licensed savings and loan associations with an attached order revising Subchapter 1 of Chapter 2 (the "Uniform Classification of Accounts") of his regulations, effective January 1, 1963.

4. Upon application by it, petitioner on March 4, 1936, became a member of the Federal Home Loan Bank of Los Angeles (hereinafter—"FHLB"), and since that date at all times petitioner has been and remains a member of such bank. (Now the Federal Home Loan Bank of San Franciso). Attached hereto and marked Exhibit 5-E is a copy of petitioner's certificate of membership dated March 4, 1936.

5. Upon application by it, petitioner on June 6, 1938, became an insured institution of the Federal Savings and Loan Insurance Corporation (hereinafter—"FSLIC") as provided in Title IV of the National Housing Act, as amended. Attached hereto and marked Exhibit 6-F is a copy of the petitioner's certificate of insurance.

6. Attached hereto and marked Exhibits 7-G and 8-H, respectively, are copies of the petitioner's Articles of Incorporation and By-Laws.

7. Attached hereto and marked Exhibit 9-I is a copy of the annual license under which petitioner was licensed

and authorized to transact the business of a savings and loan association in the State of California during the calendar year 1963. Similar annual licenses have authorized petitioner to transact such business during years prior and subsequent to 1963.

8. The FSLIC is a corporation created by the laws of the United States under the National Housing Act of 1934. (12 U.S.C.A. § 1724, et seq.). The FSLIC operates under the direction of the Federal Home Loan Bank Board (hereinafter—"FHLB Board").

9. By statute, the FSLIC had an original capital stock of $100,000,000, all of which was subscribed for originally by the Home Owners Loan Corporation. This stock was eventually transferred to the Secretary of the Treasury of the United States. By amendments in 1950 to the National Housing Act, the FSLIC was authorized and directed to pay off and retire annually at par an amount of its capital stock equal to 50% of its net income for the fiscal year. On July 1, 1958, the FSLIC completed retirement of its outstanding capital stock.

10. Prior to January 1, 1962, each insured institution was required by Section 1727(a) of Title 12 of the United States Code (12 U.S.C.A. § 1727(a)) to pay to the FSLIC an annual premium of 1/12 of 1% of the total amount of all savings accounts and creditors' obligations, for insurance by the FSLIC of its depositors' savings accounts. Such annual payments have consistently been deducted as ordinary and necessary business expenses in carrying on the savings and loan business.

11. On Sepember 8, 1961, Congress enacted Public Law 87-210 which, among other provisions, amended Section 404 of the National Housing Act. A copy of Public Law 87-210 is attached hereto and marked Exhibit 10-J. Hereinafter, payments made by the petitioner pursuant to Section 1727(b)(1) of Title 12, United States Code (12 U.S.C.A. § 1727(b)(1)) as amended will be referred to as "Section 1727(b) payments," and payments made by the petitioner pursuant to Section 1727(d) of Title 12 (12 U.S.C.A. § 1727(d)) will be referred to as "Section 1727(d) payments."

12. Attached hereto and marked Exhibits 11-K and 12-L, respectively, are copies of Senate Report No. 778

and House Report No. 823, both of the 87th Congress, 1st Session, which reports accompanied the legislation resulting in Public Law 87-210. Attached hereto and marked Exhibit 13-M are copies of 5 schedules (identified as Exhibit A, Exhibit B, Exhibit C, Schedule 1 and Schedule 2) which were prepared in the Office of the Comptroller of the FSLIC and submitted to the Senate Committee of Banking and Currency subsequent to the printing of Senate Report No. 778. These exhibits and schedules use the same "assumptions" used in Exhibits A through E of Senate Report No. 778.

13. During the calendar years 1962 through 1967, the petitioner made payments to the FSLIC as follows:

Year	§ 1727(b) Payments	§ 1727(d) Payments
1962	$ 93,258.58	$ 126,759.48
1963	135,760.52	882,636.86
1964	196,413.86	450,829.68
1965	271,477.00	1,095,089.00
1966	317,427.60	1,226,064.76
1967	373,025.38	None

14. On its Federal income tax returns for the above years, petitioner deducted all sums paid by it to the FSLIC as listed above under both Section 1727(b) and Section 1727(d) under "other deductions" as "Federal insurance premiums." Interest credited by the FSLIC to petitioner's pro rata share of the secondary reserve pursuant to Section 1727(e) (hereinafter—"Section 1727(e) interest") was not reported on petitioner's returns. Upon examination of its returns for the taxable years 1962, 1963 and 1964, the Commissioner allowed the deduction for the amounts paid under Section 1727(b), but disallowed the deduction for the amounts paid under Section 1727(d).

15. Attached hereto and marked Exhibit 14-N are copies of "Insurance Premium Notices" received by petitioner from the FSLIC for the payment due under Section 1727(b) for the calendar years 1962 through 1967. Attached hereto and marked Exhibit 15-O are copies of "Notice of insurance premium prepayment" received by

petitioner from the FSLIC for the payments due under Section 1727(d) for the calendar years 1962 through 1967.

16. Attached hereto and marked Exhibit 16-P is a copy of a memorandum dated May 21, 1962, which was issued by the State of California, Division of Savings & Loan, to all California licensed savings and loan associations. This ruling was modified and incorporated into the "Uniform Classification of Accounts" effective January 1, 1963, as set forth in Exhibit 4-D at page 54 under the heading "Contributions to the Secondary Reserve-FSLIC." All subsequent "Uniform Classification of Accounts" published by the California Savings and Loan Commissioner have required identical treatment of the "Contributions to the Secondary Reserve-FSLIC" as set forth at page 54 of Exhibit 4-D.

17. Attached hereto and marked Exhibits 17-Q, 18-R, 19-S, 20-T and 21-U, respectively, are copies of the petitioner's "Financial Statements" and "Accountant's Report" for each of the calendar years 1962 through 1966. On petitioner's balance sheet for the year 1962, the payments made pursuant to Section 1727(d) and the Section 1727(e) interest credited to petitioner's account by the FSLIC were included in "Other Assets." Beginning with 1963, the Section 1727(d) payments and the Section 1727(e) interest have been shown on the asset side of the balance sheet as "Prepaid Federal Savings and Loan Insurance Corporation Premiums." The Section 1727(d) payments were not included as expense on any of the "Statement of Operations" for the period 1962 through 1966. The interest credited to petitioner's account pursuant to Section 1727(e) by the FSLIC for each of the years 1962 through 1966 was included in miscellaneous income on each of the "Statement of Operations" for the year in which the interest was credited to petitioner's account by the FSLIC.

18. Attached hereto and marked Exhibits V, W, X, Y and Z, respectively, are "Consolidated Financial Statements" for each of the years 1962 through 1966 for First Lincoln Financial Corporation and subsidiaries. With respect to the petitioner, the same financial figures set forth

on Exhibits 17-Q through 21-U were used in these consolidated financial statements. For the calendar years 1962 through 1964, the Section 1727(d) payments by petitioner together with its Section 1727(e) interest were included on the asset side of the consolidated balance sheets in "Other Assets." For the calendar years 1965 and 1966, the Section 1727(d) payments and Section 1727(e) interest of petitioner is shown as "Prepaid Federal Savings and Loan Insurance Corporation premiums."

19. The regulations of the FHLB Board require each savings and loan association, which is a member of the Federal Home Loan Bank system, to file, on forms provided by the Board, a semiannual report of its affairs as of the end of each semiannual period. Printed instructions for the preparation of such reports are published and distributed to each member. The "Introduction" to these instructions provide "These instructions are provided to assist in the completion of monthly and semiannual reports by members of the Federal Home Loan Bank system. Each reporting institution is urged to carefully follow these instructions . . ." The instructions further provide that the reports may be submitted on either a cash or accrual basis, in conformity with the accounting method used by the institution in keeping its books. Attached hereto and marked Exhibit 27-AA is a copy of the FHLB Board instructions for reporting "Other Assets," as in effect during the years 1962 through 1966. Attached hereto and marked Exhibit 28-AB is a copy of the report filed by petitioner with the FHLB Board for the close of business December 31, 1963. In all of its reports to the FHLB Board since 1962, the petitioner has reported its pro rata share of the "Secondary Reserve" in the same manner as set forth on Exhibit 28-AB.

20. Payments made by insured institutions pursuant to Section 1727(d) have been credited on the books and records of the FSLIC directly to an account entitled "Secondary Reserve." Effective with the first payments pursuant to Section 1727(d) made by insured institutions, the FSLIC has maintained separate accounts for each insured institution showing, among other things, the amount of payment pursuant to Section 1727(d), the in-

terest credited by the FSLIC to the account pursuant to Section 1727(e), and the insured institution's pro rata share of the secondary reserve. Attached hereto and marked Exhibit 29-AC is a copy of the account maintained by the FSLIC for the petition. Attached hereto and marked Exhibit 30-AD are copies of "Status of Insurance Premium Prepayment Account" as of December 31, 1963; December 31, 1965; December 31, 1966; and December 31, 1967; received by petitioner on the FSLIC. Petitioner believes that a similar document was received from the FSLIC as of December 31, 1962 and December 31, 1964, but cannot locate such in its files and records at the present time.

21. Attached hereto and marked Exhibits 31-AE, 32-AF, 33-AG, 34-AH and 35-AI, respectively, are copies of the financial statements distributed by the FSLIC for the fiscal year ended June, 1963, and calendar years 1964-1967.

22. Attached hereto and marked Exhibit 36-AJ is a copy of the "Rules and Regulations for Insurance of Accounts" issued by the FSLIC, which were in effect in 1963.

23. Attached hereto and marked Exhibits 37 through 41, respectively, are copies of the annual reports of the Federal Home Loan Bank Board for the calendar years 1962 through 1966, which were submitted to the Congress of the United States pursuant to Section 1727(b) of the Federal Home Loan Bank Act.

24. Members of the Federal Home Loan Bank system are not required to insure the savings accounts of its depositors with the FSLIC.

25. The petitioner concedes the correctness of all of the adjustments made by respondent for the taxable year ended December 31, 1963 (page 5 of the statutory notice), with the exception of the adjustment (b) entitled "Federal Insurance Premuium Expense."

26. Attached hereto and marked Exhibit 42 is a copy of a report to the Congress of the United States by the Comptroller General of the United States dated October 1964 regarding the audit of the FSLIC for the year ended June 30, 1963. Attached hereto and marked Ex-

hibit 43 is a copy of a report to the Congress of the United States by the Comptroller General of the United States dated May 1967 regarding the audit of the FSLIC for the period July 1, 1963 through December 31, 1965. Respondent stipulates only to the authenticity of Exhibits 42 and 43, and reserve all other objections to the admission of these exhibits as evidenced in this case.

27. Attached hereto and marked Exhibit 44 in a copy of the statement of John E. Horn, Chairman, Federal Home Loan Bank Board, before the Subcommittee on Financial Institutions of the Committee of Banking and Currency, United States Senate, regarding S. 3158, 89th Cong., April 4, 1966, together with a transmittal letter by John E. Horn dated April 12, 1966, transmitting a copy of such testimony to each insured savings and loan association. Respondent stipulates only to the authenticity of Exhibit 44, and reserves all other objections to the admission of this exhibit as evidence in this case.

28. Attached hereto and marked Exhibits 45, 46 and 47, respectively, are copies of the annual reports of the California Savings and Loan Commissioner for the calendar years 1959, 1963 and 1966.

29. Attached hereto and marked Exhibit 48 is a copy of a report to the Congress of the United States by the Comptroller General of the United States dated December 1961 regarding the audit of the FSLIC for the fiscal year ended June 30, 1961. Attached hereto and marked Exhibit 49 is a copy of a report to the Congress of the United States by the Comptroller General of the United States dated January 1963 regarding the audit of the FSLIC for the fiscal year ended June 30, 1962. Respondent stipulates only to the authenticity of Exhibits 48 and 49, and reserves all other objections to the admission of these exhibits as evidence in this case.

/s/ Adam G. Bennion
Counsel for Petitioner

/s/ Lester R. Uretz
LESTER R. URETZ
Chief Counsel
Internal Revenue Service

STIPULATION EXHIBIT 4-D
Letter and Revision of Uniform Classification of Accounts

540 Van Hess Avenue
San Francisco 2

PRESTON N. SILBAUGH
COMMISSIONER

3460 Wilshire Blvd.
Los Angeles 5

EDMUND G. BROWN
GOVERNOR

STATE OF CALIFORNIA
DIVISION OF SAVINGS AND LOAN

Los Angles
December 4, 1962

TO: All State-Licensed Savings and Loan Associations

RE: Uniform Classification of Accounts

Attached is a copy of the Savings and Loan Commissioner's order in the above matter. It was filed with the Secretary of State on November 29, 1962, and will become effective on January 1, 1963.

The principal revisions made since the preceding Uniform Classification of Accounts was filed on May 2, 1956, are as follows:

* * * *

Uniform Classification of Accounts
#2

7. The following additional accounts have been provided:

Additions Account Number	
* * * *	
197	Contributions to Secondary Reserve—F.S.L.I.C.
* * * *	

Uniform Classification of Accounts
#4

Questions of interpretation may be submitted to the office of the Savings and Loan Commissioner, 3460 Wilshire Boulevard, Los Angeles 5, or 540 Van Ness Avenue, San Francisco 2.

We wish to thank those who offered suggestions to our staff during the long course of revision. We especially acknowledge the contributions of the California Savings and Loan League, the Society of Savings and Loan Controllers, the Committee for Savings and Loan of the California State Society of Certified Public Accounts and the many individual accounts, whose thoughtful comments did much to enrich the product.

/s/ Preston N. Slibaugh
PRESTON N. SILBAUGH
Savings and Loan Commissioner

Enclosure

STATE OF CALIFORNA
DEPARTMENT OF INVESTMENT
DIVISION OF SAVINGS AND LOAN

ORDER ADOPTING, AMENDING, OR REPEALING REGULATIONS OF THE SAVINGS AND LOAN COMMISSIONER

After proceedings had in accordance with the provisions of the Administrative Procedure Act (Gov. Code, Title 2, Div. 3, Part 1, Chapter 4) and pursuant to the authority vested by Section 5255 of the Financial Code, and to implement, interpret, or make specific Section 8701 of the Financial Code, the Savings and Loan Commissioner hereby repeals, amends, revises and adopts his regulations in Title 10, California Administrative Code, as follows:

Adopts new Subcapter 1 of Chapter 2 to read:

* * * *

CLASSIFICATION OF ACCOUNTS

ASSET ACCOUNTS

Account No.	Account Name	FHLBB Annual Report Exhibit "A" Line No.
	* * * *	
OTHER ASSETS		
	* * * *	
194	Prepaid Expenses and Deferred Charges	
194-1	Assessments (State License, League Dues, etc.)	14
194-2	Surety Bond Premiums	
194-3	Federal Savings and Loan Insurance Corporation Premiums	
194-4	Other Insurance Premiums	14
194-5	Taxes	
194-6	Acquisition Cost of Loans	
194-7	Other Prepaid Expenses and Deferred Charges	
	* * * *	
197	Contribution to Secondary Reserve—F.S.L.I.C	15

* * * *

EXPLANATORY TEXT OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNTS

* * * *

194 Preferred Expenses and Deferred Charges

This account, if carried, shall reflect that portion of expenses paid or accrued applicable to future periods and shall indicate the proper segregation thereof in the ledger according to the subaccounts set forth in the Uniform Classification of Accounts under Account No 194.

* * * *

197 Contributions to the Secondary Reserve—FSLIC

This account shall be debited for the annual prepayment to the FSLIC Secondary Reserve. Interest earned on the prepayments is recorded by a debit to this account and a credit to Account No. 407. Transfer to the Primary Reserve is recorded by crediting this account and debiting Account No. 511.

Both the interest and transfer entries are made at the time of notification by the insurer.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
WASHINGTON

INSURANCE PREMIUM NOTICE

Lincoln Savings and Loan Association
630 West Sixth Street
Los Angeles 17, California

Date MAY 2 2 1963

2066

Under provisions of Title IV, Section 404 (b) (1), of the National Housing Act, as amended, and Rules and Regulations for Insurance of Accounts, premium for insurance is assessed upon the total amount of all accounts of insured members plus creditor obligations. Items 14, 20a

Amount subject to premium charge per statement of condition as of	April 30, 1963	$ 162,912,620.71
ANNUAL PREMIUM at rate of 1/12 of 1%		$ 135,760.52
FIRST HALF of premium due	June 6, 1963	$ 67,880.26
SECOND HALF of premium due	December 6, 1963	$ 67,880.26

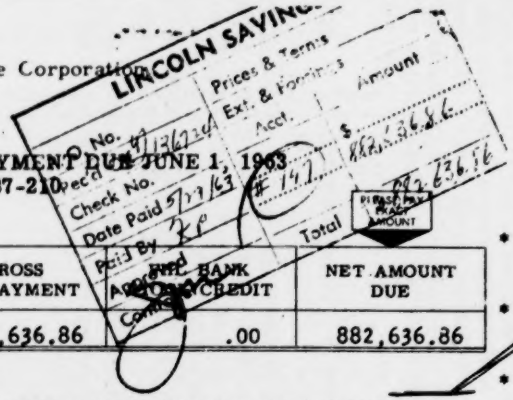
Note: Your cancelled check is your receipt. No other form of receipt will be furnished unless requested. To assure proper credit return yellow copy of this notice with CHECK MADE PAYABLE TO FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION.

Mail to:—Comptroller, Federal Savings and Loan Insurance Corporation.
101 Indiana Avenue, N. W.
Washington 25, D. C.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1962 661809

Federal Savings and Loan Insurance Corporation
Washington 25, D.C.

STATEMENT OF INSURANCE PREMIUM PREPAYMENT DUE JUNE 1, 1963 PURSUANT TO PUBLIC LAW 87-210



ALL ACCOUNTS OF INSURED MEMBERS			GROSS PREPAYMENT	FHL BANK ADJUSTMENT CREDIT	NET AMOUNT DUE
December 31, 1962	December 31, 1961	Increase			
134,873,645	90,741,802	44,131,843	882,636.86	.00	882,636.86

LINCOLN SVGS & LN ASSN
630 WEST SIXTH ST
LOS ANGELES CALIF

TO ASSURE PROPER CREDIT PLEASE RETURN COPY OF THIS NOTICE WITH PAYMENT AND INDICATE THE FOLLOWING ACCOUNT NUMBER ON REMITTANCE:

2,066

Please make check payable to Federal Savings and Loan Insurance Corporation and mail to Comptroller, FSLIC, 101 Indiana Avenue N.W., Washington 25, D.C.

NOTICE OF INSURANCE PREMIUM PREPAYMENT DUE JUNE 1, 1965

PLEASE PAY EXACT AMOUNT

ALL ACCOUNTS OF INSURED MEMBERS			GROSS PREPAYMENT	FHL BANK STOCK CREDIT	NET AMOUNT DUE
December 31, 1964	December 31, 1963	Increase			
268,109,579	196,620,129	71,489,450	1,429,789.00	334,700.00	1,095,089.00

LINCOLN SAVINGS & LOAN ASSOCIATION
630 WEST SIXTH STREET
LOS ANGELES CALIFORNIA

TO ASSURE PROPER CREDIT PLEASE RETURN COPY OF THIS NOTICE WITH PAYMENT AND INDICATE THE FOLLOWING ACCOUNT NUMBER ON REMITTANCE:

2,066

Please make check payable to Federal Savings and Loan Insurance Corporation and mail to Comptroller, Federal Home Loan Bank Board, 101 Indiana Avenue N.W.. Washington, D.C. 20552

Federal Savings and Loan Insurance Corporation
Washington, D.C. 20552

NOTICE OF INSURANCE PREMIUM PREPAYMENT DUE JUNE 1, 1964

PLEASE PAY EXACT AMOUNT

ALL ACCOUNTS OF INSURED MEMBERS			GROSS PREPAYMENT	FHL BANK STOCK CREDIT	NET AMOUNT DUE
December 31, 1963	December 31, 1962	Increase			
196,620,129	134,873,645	61,746,484	1,234,929.68	784,100.00	450,829.68

LINCOLN SAVINGS & LOAN ASSOCIATION
630 WEST SIXTH STREET
LOS ANGELES CALIFORNIA

LINCOLN SAVINGS
Prices & Terms
Ext. & Footings
Acct. | Amount
Acct. No. 2
Rec'd OK
Check No. 59323
Date Paid 5/28/64 19 $
Paid By
Controller

TO ASSURE PROPER CREDIT PLEASE RETURN COPY OF THIS NOTICE WITH PAYMENT AND INDICATE THE FOLLOWING ACCOUNT NUMBER ON REMITTANCE:

2,066

Please make check payable to Federal Savings and Loan Insurance Corporation and mail to Comptroller, Federal Home Loan Bank Board, 101 Indiana Avenue N.W.. Washington, D.C. 20552

STIPULATION EXHIBIT 16-P

CALIFORNIA MODIFICATION OF UNIFORM CLASSIFICATION OF ACCOUNTS FOR SECTION 404(d) PAYMENTS

STATE OF CALIFORNA
DIVISION OF SAVINGS AND LOAN

DATE: May 21, 1962

TO: All State Licensed Savings and Loan Associations
RE: Procedure for Accounting for Prepayment of Federal Insurance Premiums Into the Secondary Reserve

In order that each association's books and records shall uniformly reflect the payment into the Federal Savings and Loan Insurance Corporation's Secondary Reserve, the following accounting procedures are to be followed:

Explanation and Account Title	Debit	Credit
1. Payment of annual prepayment to FSLIC		
Acct. No. 193—Sundry Debit Items—prepayment to FSLIC Secondary Reserve	xxx	
Acct. No. 102—Cash in Bank		xxxx
2. Recording return credited to Secondary Reserve		
Acct. No. 193—Sundry Debit Items—prepayment to FSLIC Secondary Reserve	xxx	
Acct. No. 408—Other Interest Income—Income on FSLIC Secondary Reserve		xxxx
3. Association notified by FSLIC that a portion of the Secondary Reserve is being transferred to the Primary Reserve		
Acct. No. 511—FSLIC Insurance Premium Expense or Prepaid Expense	xxx	
Acct. No. 193—Sundry Debit Items—prepayment to FSLIC Secondary Reserve		xxxx

Associations are requested to submit all questions of doubtful interpretation to the San Francisco or Los Angles offices of the Commissioner.

An excellent digest and summary of the revised requirements relative to Federal Home Loan Bank stock ownership, Federal Savings and Loan Insurance Corporation insurance premium, and the Federal Savings and Loan Insurance Corporation Secondary Reserve payment is given in the United States Savings and Loan League's Special Management Bulletin S#91.

/s/ Kenneth E. Scott
KENNETH E. SCOTT
Chief Deputy
Savings and Loan Commissioner

STIPULATION EXHIBIT 27-AA

FEDERAL HOME LOAN BANK BOARD INSTRUCTIONS FOR REPAIRING SECTION 404(d) PAYMENTS

* * * *

Schedule D, Other Assets

Assets of the type specified in this schedule and assets that cannot otherwise properly be reported under the asset categories set forth in Items 1 through 10 of Exhibit I will be reported in Schedule D.

Member institutions insured by the Federal Savings and and Loan Insurance Corporation will report on line 1 that portion of the insurance premium paid to the Corporation which is being carried on the books as a prepaid item to be charged to operating expense in the next fiscal period.

An institution insured by the Federal Savings and Loan Insurance Corporation will report on line 2 the amount of its pro rata share in the Secondary Reserve established by the Corporation from the premium prepayments. Such pro rata share includes earnings credited on the premium prepayments by the Corporation. The statement furnished by the Corporation each December shows the total amount of the insured institution's premium prepayments and the earnings credited thereon by the Corporation.

If the books of the reporting institution are kept on an accrual basis, report on line 3 the amount of prepaid expenses chargeable against operations of future periods.

Accrued interest on securities and other investments, where accrued and recorded on the books, will be reported on line 4. Accrued interest on mortgage loans and other loans will not be included here, but will be reported in Schedules A and B.

Line 5 will show, against concise but clear captions, the amount of each other asset or group of assets which cannot be reported properly against Items 1 to 10, inclusive,

or Exhibit I or under any of the preceding captions of this schedule.

A newly insured mutual instiution may experience an operating defiicit until such time as earnings permit it to be self supporting. If the Corporation has required the organizers and/or directors to pledge savings accounts to protect the institution against such operating deficits, any such deficit should be transferred to an account captioned "Accounts Receivable Secured by Pledged Shares". Any balance in such an account should be shown as a part of "Other Assets" on Exhibit I and detailed on Schedule D.

The total of other assets shown on line 6 of this schedule is to be reported at line 11 of Exhibit I.

• • • •

STIPULATION EXHIBIT 29-AC

FSLIC'S SECTION 404(d) PAYMENTS ACCOUNTS FOR LINCOLN SAVINGS LOAN ASSOCIATION

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

INSURANCE PREMIUM PREPAYMENT ACCOUNT

DKT NO. J EXH

LINCOLN SAVINGS & LOAN ASSOCIATION
650 WEST SIXTH STREET
LOS ANGELES CALIFORNIA

REFERENCE CODES
1. BILLING
2. PREPAYMENT
3. RETURN
4. TRANSFER OF BALANCE
5. CREDIT OF REGULAR PREMIUM
6. OTHER (SEE REMARKS)

DATE	REFERENCE COD	REFERENCE NO	ACCOUNTS RECEIVABLE: ALL ACCOUNTS OF INSURED MEMBERS YEAR	AMOUNT	INCREASE OVER PRIOR YEAR	GROSS PREPAYMENT	FHLB STOCK CR.	NET AMOUNT DUE
12/31/63	1		1962	134,873,645	OPENING BALANCES NEW SYSTEM			
12/31/63	3	JVP-2						
6/ 1/64	1	JVP-3	1963	196,620,129	61,746,484	1,234,929.68	784,100.00	450,829.68
5/28/64	2	PP-94						
12/31/64	3	JVP-4						
06/01/65	1	JVP-5	1964	268,109,579	71,489,450	1,429,789.00	334,700.00	1,095,089.00
06/01/65	2	PP133						
12/31/65	3	JVP-6						
06/01/66	1	JVP-7	1965	329,412,817	61,303,238	1,226,064.76	.00	1,226,064.76
05/31/66	2	PP168						
12/31/66	3	JVP-8						
06/01/67	1	JVP-9	1966	327,468,679	1,944,138-	.00	.00	.00
06/01/67	2	PP---						
12/31/67	3	JVP10						
12/31/67	4			368,568,921				

* TRANSFERRED FROM ACCOUNT NO 4082 DUE TO MERGER

OVERSIZE PAGE SEE NEXT FRAME

STIPULATION EXHIBIT 29-AC

FSLIC'S SECTION 404(d) PAYMENTS ACCOUNTS FOR LINCOLN SAVINGS LOAN ASSOCIATION

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

INSURANCE PREMIUM PREPAYMENT ACCOUNT

DKT NO. 325-67
J EXH. 29-AC

ACCOUNT NO. 2066

REFERENCE CODES

1. BILLING
2. PREPAYMENT
3. RETURN
4. TRANSFER OF BALANCE
5. CREDIT OF REGULAR PREMIUM
6. OTHER (SEE REMARKS)

DATE INSURED MON DAY YEAR 6 06 38

ACCOUNTS RECEIVABLE				PRO RATA SHARE OF SECONDARY RESERVE		
ED MEMBERS INCREASE OVER PRIOR YEAR	GROSS PREPAYMENT	FHLB STOCK CR.	NET AMOUNT DUE	DR.	CR.	BALANCE
OPENING BALANCES NEW SYSTEM						1,011,738.44
61,746,484	1,234,929.68	784,100.00	450,829.68		22,951.42	1,034,689.86
					450,829.68	1,485,519.54
					44,864.25	1,530,383.79
71,489,450	1,429,789.00	334,700.00	1,095,089.00			
					1,095,089.00	2,625,472.79
					77,231.97	2,702,704.76
61,303,238	1,226,064.76	.00	1,226,064.76			
					1,226,064.76	3,928,769.52
					131,295.86	4,060,065.38
1,944,138-	.00	.00	.00			
					.00	4,060,065.38
					171,832.97	4,231,898.35
					690,217.11*	4,922,115.46
82 DUE TO MERGER						

ACCOUNT (

INSURANCE PREMIUM PREPAYMENT

LINCOLN SAVINGS AND LOAN ASSOCIATION
630 WEST SIXTH STREET
LOS ANGELES 17, CALIFORNIA

ACCOUNTS RECEIVABLE

A/C No.	DATE	ALL ACCOUNTS OF INSURED MEMBERS					GROSS PREPAYMENT	FHL STOCK
		DECEMBER 31		DECEMBER 31		INCREASE		
2,066	JUNE 1 62	1961	90,741,802	1960	84,403,828	6,337,974	126,759.48	
2,066	JUNE 1 63	1962	134,873,645	1961	90,741,802	44,131,843	882,636.86	

PAYMENT RECORD

A/C No.	DATE	REF. NO.	RETURN			DR.	
			PERIOD	AVE. YEARLY BAL.	RATE		
2,066	MAY 31 62	PP-16					126
2,066	DEC 31 62	JVP 1	6-1 TO 12-31-62	74,319	.03151433		2
2,066	MAY 31 63	PP-54					882

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FOR REMAINDER OF PAGE

INSURANCE PREMIUM PREPAYMENT

ACCOUNT (CERTIFICATE) No. 2088

DATE INSURED 6-6-38

IATION

ACCOUNTS RECEIVABLE

OUNTS OF INSURED MEMBERS				GROSS PREPAYMENT	FHL BANK STOCK CREDIT	NET AMOUNT DUE (DR)	
31	DECEMBER 31		INCREASE				
741,802	1960	84,403,828	6,337,974	126,759.48	.00	126,759.48	.00
873,645	1961	90,741,802	44,131,843	882,636.86	.00	882,636.86	.00

PAYMENT RECORD

RETURN			DR.	CR.	BALANCE	
PERIOD	AVE. YEARLY BAL.	RATE				
1 TO 12-31-62	74,319	.03151433		126,759.48	126,759.48	
				2,342.10	129,101.58	
				882,636.86	1,011,738.44	.00

STATUS OF INSURANCE PREMIUM PREPAYMENT ACCOUNT

STATUS OF INSURANCE PREMIUM PREPAYMENT ACCOUNT AS OF DECEMBER 31, 1963

BALANCE 12/31/63 BEFORE RETURN	RETURN CREDITED 12/31/63		BALANCE 12/31/63 AFTER RETURN
	RATE *	AMOUNT	
1,011,738.44	3.549594%	22,951.42	1,034,689.86

2060
LINCOLN SAVINGS & LOAN ASSOCIATION
630 WEST SIXTH STREET
LOS ANGELES CALIFORNIA

* AS REQUIRED BY LAW, THIS RETURN WAS COMPUTED AT A RATE EQUAL TO THE AVERAGE ANNUAL RATE OF RETURN TO THE CORPORATION ON ITS INVESTMENTS IN UNITED STATES GOVERNMENT SECURITIES FOR THE TWELVE-MONTHS PERIOD ENDED NOVEMBER 30, 1963.

Federal Savings and Loan Insurance Corporation
Washington, D. C. 20552

STATUS OF INSURANCE PREMIUM PREPAYMENT ACCOUNT AS OF DECEMBER 31, 1967

BALANCE 12/31/67 BEFORE RETURN	RETURN CREDITED 12/31/67 RATE*	AMOUNT	BALANCE 12/31/67 AFTER RETURN
4,722,256.75 (a)	4.232271%	199,859.71	4,922,116.46

(a) Includes Lincoln SGLA, Washington SGLA and Lifetime SGLA

*AS REQUIRED BY LAW, THIS RETURN WAS COMPUTED AT A RATE EQUAL TO THE AVERAGE ANNUAL RATE OF RETURN TO THE CORPORATION ON ITS INVESTMENTS IN UNITED STATES GOVERNMENT SECURITIES FOR THE TWELVE-MONTH PERIOD ENDED NOVEMBER 30, 1967

2066
LINCOLN SAVINGS AND LOAN ASSOCIATION
630 WEST SIXTH STREET
LOS ANGELES CALIFORNIA 90017

fr #5949
dt 12/24/67

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
WASHINGTON, D.C. 20552

38

Recd 12/26 from San Diego field

STATUS OF INSURANCE PREMIUM PREPAYMENT ACCOUNT AS OF DECEMBER 31, 1966

BALANCE 12/31/66 BEFORE RETURN	RETURN CREDITED 12/31/66 RATE *	AMOUNT	BALANCE 12/31/66 AFTER RETURN
3,928,769.52	3.837323%	131,295.86	4,060,065.38

D. 127 131,295.86

2066 C. 5.07 131,295.96

LINCOLN SAVINGS & LOAN ASSOCIATION
630 WEST SIXTH STREET
LOS ANGELES CALIFORNIA

* AS REQUIRED BY LAW, THIS RETURN WAS COMPUTED AT A RATE EQUAL TO THE AVERAGE ANNUAL RATE OF RETURN TO THE CORPORATION ON ITS INVESTMENTS IN UNITED STATES GOVERNMENT SECURITIES FOR THE TWELVE MONTH PERIOD ENDED NOVEMBER 30, 1966.

TAX COURT OF THE UNITED STATES
51 T.C. No. 10

[Caption Omitted]

FINDINGS OF FACT AND OPINION

(Filed October 21, 1968)

Petitioner, a California savings and loan association, insures the accounts of its depositors with the Federal Savings and Loan Insurance Corporation (FSLIC). It pays regular annual premiums for such insurance coverage, which are deductible. Such premiums are part of FSLIC's gross income, available to meet all current expenses and losses, and to the extent not so used are transferred to FSLIC's "Primary Reserve" to meet losses of future years. Since 1962, petitioner has also been required to make additional annual payments "in the nature of * * * prepayment[s] with respect to future premiums." Such "prepayments" immediately become part of the FSLIC's "Secondary Reserve," which is available to a limited extent to meet future losses in the event of depletion of all other resources of the FSLIC. Although petitioner has no interest in the Primary Reserve, it has a pro rata interest in the Secondary Reserve. That interest is reflected in an account which is rendered to it annually by the FSLIC showing the amount of the "prepayments" made by petitioner together with an annual "return" computed upon the balance in the account at the end of each year. The balance in such account is to be used to discharge petitioner's obligation to pay its regular insurance premiums in future years after the total of FSLIC's Primary Reserve and Secondary Reserve reaches a certain level, but petitioner may transfer its account (its pro rata interest in the Secondary Reserve) to another insured institution in the event of merger, consolidation or bulk sale, and may recover any unused balance in its account in cash if it terminates insurance with the FSLIC or liquidates. Petitioner's pro rata share of the Secondary Reserve appears on its financial state-

ments and the consolidated statements of its parent as an asset, and both State and Federal regulatory agencies require that the "prepayments" be capitalized and not expensed until used to pay premiums or cover losses. *Held* the "prepayments" are also capital expenditures for Federal income tax purposes, deductible only in the years and to the extent used to discharge petitioner's obligation to pay regular insurance premiums or to meet actual losses of the FSLIC.

Adam Y. Bennion, A. Calder Mackay and *Richard N. Mackay*, for the petitioner.

James A. Thomas, for the respondent.

The Commissioner determined a deficiency in petitioner's income tax of $461,454.38 for the year 1963. Petitioner disputes so much of that deficiency as is based upon the Commissioner's disallowance of a deduction in the amount of $882,636.86, which petitioner claimed as a "Federal Insurance Premium" expense in that year. Petitioner paid this amount to the Federal Savings and Loan Insurance Corporation in 1963, as well as its regular annual insurance premium for that year, as it was required to do by 12 U.S.C. sec.1727(d), which section characterized the payment as an "additional premium in the nature of a prepayment with respect to future premiums." The issue for decision is whether such payment was an ordinary and necessary expense of petitioner's business in 1963, or whether it was a capital expenditure deductible, if at all, only when actually used to discharge petitioner's obligation to pay regular annual insurance premiums or to meet insurance losses of the Federal Savings and Loan Insurance Corporation.

FINDINGS OF FACT

Some of the facts have been stipulated and, as stipulated, are incorporated herein by this reference together with accompanying exhibits.

Lincoln Savings and Loan Association (hereinafter sometimes referred to as "petitioner") is a corporation organized under the laws of the State of California, incorporated on February 6, 1925. It's name, originally Lincoln Building & Loan Association, was changed on

August 5, 1943 to Lincoln Savings and Loan Association. At the date of the filing of the petition in this case, petitioner's principal office was located at 630 West Sixth Street, Los Angles, California. It filed its tax returns for the calendar years 1962, 1963 and 1964 on the cash receipts and disbursements basis of accounting with the district director of internal revenue, Los Angeles, California.

All of petitioner's outstanding stock (consisting of 2,500 shares with a par value of $100 per share) has been owned since 1964 by First Lincoln Financial Corporation, which is a corporation organized under the laws of the State of California with its principal office in Los Angeles, California. During 1962 and 1963, First Lincoln Financial Corporation owned 98.88 percent of petitioner's outstanding stock. On December 31, 1963, First Lincoln Financial Corporation had 1,402,654 shares of stock outstanding, without par value, owned by approximately 2,800 shareholders. Its stock is traded over-the-counter.

Petitioner was licensed as a savings and loan association by the Savings and Loan Commissioner of the State of California on February 6, 1925, and since that date has been and remains a licensed savings and loan association under the laws of the State of California, transacting business in the Los Angeles area. As such, it is regulated by Division II of the California Financial Code (West's Annotated California Codes, Financial Code, Section 5000, *et seq.*) and by regulations of the California Savings and Loan Commissioner, which law and regulations are incorporated herein by reference.

Petitioner is a member of the Federal Home Loan Bank of San Francisco, one of twelve regional district banks established and supervised by the Federal Home Loan Bank Board (hereinafter sometimes referred to as the FHLB Board) under authority of the Federal Home Loan Bank Act of 1932. See 12 U.S.C. sec. 1423. These banks provide additional liquidity and funds for mortgage lending by making advances to member institutions as needed to meet unusual or heavy withdrawal and credit demands. As a condition of membership, each member institution is required to purchase capital stock in its bank

equal to one percent of its outstanding "unpaid loan principal," and to invest in such amounts of stock thereafter as is necessary to maintain this percentage. 12 U.S.C. sec. 1426(c). Prior to 1962 the statutory level was two percent but thereafter, as part of a comprehensive legislative plan calling for certain additional payments by "insured institutions" to the Federal Savings and Loan Insurance Corporation, as hereinafter set forth, the level was reduced to one percent.

Since 1938, petitioner has been an "insured institution" of the Federal Savings and Loan Insurance Corporation (hereinafter sometimes referred to as the FSLIC), a corporation created by the laws of the United States under Title IV of the National Housing Act of 1934, 12 U.S.C. sec. 1724 *et seq.*, and operated under the direction of the FHLB Board, which is required by statute to insure the accounts of all Federal savings and loan associations, and is permitted to insure the accounts of qualified state-chartered savings and loan associations, such as petitioner. 12 U.S.C. sec. 1726. Members of the Federal Home Loan Bank system are not required to insure the savings accounts of their depositors with the FSLIC, unless they are also Federally-chartered savings and loan associations. Similarly, except for Federal savings and loan associations, any insured institution of the FSLIC may voluntarily terminate such insurance, provided adequate notice is given to depositors and other technical requirements are met; the FHLB Board may, however, direct an involuntary termination of the insurance of any insured institution under certain conditions, though it has done so only once in the history of the FSLIC. Petitioner placed a great deal of emphasis in its advertising upon the fact that it was a Federally insured institution and, in the opinion of its management, loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors.

Prior to January 1, 1962, each insured institution was required by section 1727(a) of Title 12 of the United States Code (sec. 404(a) of the National Housing Act) to pay an annual insurance premium to the FSLIC equal to 1/12 of 1 percent of the total amount of its savings

accounts and creditor obligations. Such premiums were to be continued until the FSLIC's reserve for losses equalled or exceeded five percent of the insured accounts and creditor obligations of all insured institutions (its potential liabilities), and at such intervals thereafter as might be required to keep the reserve fund at this level. Public Law 87-210, 75 Stat. 482, pertinent parts of which are set forth in the margin,[1] amended section 1727 of

[1] Public Law 87-210 amended section 404 of the National Housing Act (12 U.S.C. sec. 1727) to read as follows:

Sec. 1727. Primary and secondary reserves.

(a) Establishment.

The Corporation shall establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) of this section and the credits made pursuant to the first sentence of subsection (e) of this section.

(b) Premiums for insurance; amount; time of payment; waiver, rules and regulations

(1) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 1726 of this title, and thereafter annually, except that under regulations prescribed by the Corporation such premium may be paid semiannually.

(2) If, at the close of any December 31, the Primary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions as of such close, no premium under paragraph (1) of this subsection shall be payable by any insured institution with respect to its premium year beginning during the year commencing on May 1 next succeeding such December 31, except that the foregoing provisions of this sentence shall not be applicable to any insured institution with respect to any of the twenty premium years beginning with the premium year commencing with the date on which such certificate is issued.

(3) The Corporation is authorized to prescribe such rules and regulations at is may determine to be necessary or appropriate to accomplish the purposes and provisions of this subsection.

* * * *

[Footnote continued on page 44]

[1] [Continued]

(d) Prepayments; amount; credit to Secondary Reserve; amount for newly insured institutions.

Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) of this section equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 1426 of this title and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve * * *.

(e) Credits to Secondary Reserve; availability for losses; assignment or transfer of share of Reserve.

The Corporation, in accordance with such regulations as it may prescribe, shall credit to the Secondary Reserve, as of the close of each calendar year a return on the outstanding balances of the Secondary Reserve during such calendar year, as determined by the Corporation, at a rate equal to the average annual rate of return to the Corporation during the year ending at the close of November 30 of such calendar year, as determined by the Corporation, on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States. Except as provided in subsections (f) and (g) of this section, the Secondary Reserve shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses. No right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined.

(f) Cessation of prepayments; distribution of share of Secondary Reserve; reinstatement of reserve share; payment; waiver, or other treat of accruals.

If (i) the status of an insured institution as an insured institution is terminated pursuant to any provision of section 1730 of this title or the insurance of accounts of an insured institution is otherwise terminated, (ii) a conservator, receiver, or other legal custodian is appointed for an insured institution under the circumstances and

for the purpose set forth in subsection (d) of section 1724 of this title, or (iii) the Corporation makes a determination that for the purposes of this subsection an insured institution has gone into liquidation, the obligation of such institution to make prepayments under subsection (d) of this section, including any prepayments as to which such institution is obligated at the time of such termination, appointment, or determination, shall cease, and the Corporation shall pay in cash to such institution its pro rata share of the Secondary Reserve, in accordance with such terms and conditions as the Corporation may prescribe by regulations or otherwise, or, at the option of the Corporation, the Corporation may apply the whole or any part of the amount which would otherwise be paid in cash toward the payment of any indebtedness or obligation, whether matured or not, of such institution to the Corporation, then existing or arising before such payment in cash * * *.

(g) Suspension of prepayments, resumption of obligation upon insufficiency of aggregate reserves; cash distribution of shares of Secondary Reserve.

If, at the close of any December 31, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions but the Primary Reserve does not equal or exceed such 2 per centum, no insured institution shall be obligated to make any prepayment under subsection (d) of this section during the year beginning with May 1 next succeeding such close, and each insured institution's pro rata share of the Secondary Reserve shall be used to the extent available, to discharge such institution's obligation for its premium under subsection (b) of this section for the premium year beginning in such year; and the suspension of obligation to make such prepayments and the use of such pro rata shares as provided in this sentence shall continue unless and until the next sentence or the last sentence of this subsection shall become operative. If, at the close of any December 31 occurring before the last sentence of this subsection shall become operative, the aggregate of the Primary Reserve and the Secondary Reserve is not at least equal to 1¾ per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions (i) the obligation of insured institutions to make prepayments under subsection (d) of this section shall resume on May 1 next following such December 31 and shall continue unless and until the first sentence or the last sentence of this subsection shall become operative, and (ii) the use of any insured institution's pro rata share of the Secondary Reserve under the first sentence of this subsection shall terminate with respect to its premium under subsection (b) of this section for the premium year beginning during the calendar year commencing on May 1 next succeeding such December 31, and such termination shall continue unless and until the first sentence of this subsection shall become operative. If, at the close of any December 31, the Primary Reserve equals or exceeds such 2 per centum, the Corpora-

Title 12 of the United States Code, effective January 1, 1962, to its present form. An annual insurance premium at the rate of 1/12 of one percent is still required of all insured institutions (provision for which is now made in section 1727(b)(1)), though the point at which such premiums are to cease and the level at which the FSLIC's general reserve is to be maintained has been lowered from five to two percent of total insured savings and creditor obligations of insured institutions. (Section 1727(b)(2)). But insured institutions are now required under the amended provisions of section 1727, to make further annual payments to the FSLIC (provided for in 12 U.S.C. sec. 1727(d) and hereinafter sometimes referred to as

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tion shall, at such time (which shall be the same for all insured institutions and shall not be later than May 1 next succeeding such close) and in such manner as the Corporation shall determine, pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not, after such time, accept or receive further prepayments under subsection (d) of this section.

Public Law 87-210 also amended section 6 of the Federal Home Loan Bank Act (12 U.S.C. sec. 1426) to read as follows:

Sec. 1426. Capital stock.

* * * *

(c) Minimum subscriptions; retirement of oversubscriptions; limitations; cancellation of oversubscriptions; aggregate unpaid loan principal; reports and information.

(1) The original stock subscription of each institution eligible to become a member under section 1424 of this title shall be an amount equal to 1 per centum of the subscriber's aggregate unpaid loan principal, but not less than $500. The bank shall annually, as of the close of the calendar year, adjust, at such time and in such manner and upon such terms and conditions as the Federal Home Loan Bank Board may by regulations or otherwise prescribe, the amount of stock held by each member so that such member shall have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the next preceding sentence (but not less than $500). If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire the stock of such member in excess of the amount so required. Said Board, in its discretion, may, by regulations or otherwise, provide for adjustments in amounts of stock to be issued or retired in order that stock may be issued or retired only in entire shares.

"section 1727(d) payments") equal to two percent of any net increase in the total amount of its insured accounts during the previous year, reduced, however, by an amount equal to any requirement, as of the end of such year, for the purchase of stock in a Federal Home Loan Bank of which the insured institution is a member. Public Law 87-210 also amended section 6 of the Federal Home Loan Bank Act (12 U.S.C. sec. 1426), to reduce the percentage of stock which a member of a Federal Home Loan Bank is required to hold in relation to its outstanding home mortgage loans, with certain exceptions relating to stock already purchased, from two to one percent. It was contemplated that, for most member institutions, the section 1727(d) "prepayment requirement would be approximately offset" by the resulting reduction in outlays for Federal Home Loan Bank stock which a member institution was theretofore (prior to 1962) required to make. H. Rept. No. 823, 87th Cong., 1st Sess., p. 2.

Under the terms of section 1727, as amended by Public Law 87-210, the FSLIC is directed to establish a "Primary Reserve," and a "Secondary Reserve". (Section 1727(a)). The Primary Reserve is credited annually with the net income of the FSLIC, and thus represents its "retained earnings." Regular insurance premiums paid by insured institutions under section 1727(b)(1) constitute one of the major items of the FSLIC's gross income, and, to the extent that such premiums exceed expenses and insurance losses in any given year, they are thus transferred as part of FSLIC's net income to the Primary Reserve. Section 1727(d) payments, on the other hand, though described in the statute as "additional premium[s] in the nature of * * * prepayment[s] with respect to future premiums," are not regarded as an item of income by the FSLIC, which is required by section 1727(a) to credit all such payments directly to the "Secondary Reserve." The FSLIC is also required to credit the "Secondary Reserve" with an annual "return" on the outstanding balances in that account at the end of each year, computed "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States."

Section 1727(e). Finally, whereas the "Primary Reserve" is "the general reserve of the Corporation [i.e., the FSLIC]," the "Secondary Reserve" is available "only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses." Section 1727(e).

Each insured institution maintains an interest in a pro rata share of the "Secondary Reserve," and though its "right, title or interest" therein is not generally transferable or assignable, the FSLIC has authority to provide for the transfer of such pro rata share "in cases of merger or consolidation transfer of bulk assets * * * and similar transactions." Section 1727(e). Moreover, an insured institution is entitled to a cash refund of its pro rata share in the event that (1) its status as an insured institution is terminated, or (2) a conservator, receiver, or other legal custodian is appointed for the purpose of liquidating the assets of the institution, or (3) the FSLIC determines that such institution has gone into voluntary liquidation. Section 1727(f).

When, at the close of any December 31, the *aggregate* of the Primary Reserve and the Secondary Reserve equals or exceeds two percent of the total amount of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make section 1727(d) payments will be suspended for the following year and all succeeding years; the obligation to make section 1727(d) payments is to resume in the year following any December 31 on which such aggregate amount falls below 1¾ percent of all insured accounts and creditor obligations, and is to terminate permanently when the amount in the Primary Reserve alone equals or exceeds two percent of such accounts and obligations. In any year in which the obligation to make section 1727(d) payments is suspended, as described above, the pro rata share of each insured institution in the Secondary Reserve will be used, to the extent available, to discharge its obligation to pay the regular insurance premium for that year. After the Primary Reserve alone reaches the two percent level, each insured institution is

entitled to the return of its pro rata share of the Secondary Reserve, if any, in cash. Section 1727(g).

A schedule appearing shortly hereinafter sets forth estimates of the reserve position of the FSLIC in terms of the expected ratio of the Primary Reserve, the Secondary Reserve, and the aggregate of the Primary and Secondary Reserves to the total of all accounts and creditor obligations of all insured institutions for the years 1962-1995. These estimates, prepared in the Office of the Comptroller of the FSLIC and submitted to the Senate Committee on Banking and Currency in connection with that Committee's consideration of the bill which became Public Law 87-210, were based upon certain assumptions, *viz:*

1. No insurance losses.[2]
2. Premium income computed on annual billing basis of one-twelth of 1 percent.
3. Investment income based on annual average rate of return of 3 percent.
4. Operating expenses based on current rate of expenditure equal to 3.7 percent of premium income.
5. Mortgage loans held estimated at 96 percent of total savings capital.
6. Net home mortgages estimated at 90 percent of mortgage loans held.
7. Annual growth in savings of $7 billion plus dividends at an annual rate of 3 percent.

In addition to the foregoing estimates, the schedule also shows the *actual* percentage of the aggregate of the Primary and Secondary Reserves to the total amount of all accounts and creditor obligations of insured institutions during the years 1963-1967, as shown on the financial statements of the FSLIC for those years. The schedule described above is as follows:

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[2] The FSLIC, during the 27 years of its existence prior to June 30, 1961, had incurred net insurance losses of only $5.1 million, approximately 1.1 percent of its cumulative gross income.

December 31	Primary reserve—estimated ratio	Secondary reserve—estimated ratio	Aggregate of primary and secondary reserve	
			Estimated ratio	Act rat
1962	0.642	0.227	0.869	
1963	0.661	0.417	1.078	*1
1964	0.685	0.581	1.266	1
1965	0.712	0.723	1.435	1
1966	0.741	0.849	1.590	1
1967	0.773	0.963	1.736	1
1968	0.807	1.067	1.874	
1969	0.842	1.148	1.990	
1970	0.879	1.177	2.056	
1971	0.917	1.052	1.969	
1972	0.956	0.935	1.891	
1973	0.996	0.825	1.821	
1974	1.036	0.720	1.757	
1975	1.078	0.620	1.699	
1976	1.121	0.667	1.787	
1977	1.164	0.710	1.874	
1978	1.208	0.752	1.960	
1979	1.252	0.792	2.045	
1980	1.298	0.696	1.994	
1981	1.343	0.603	1.946	
1982	1.390	0.512	1.902	
1983	1.437	0.424	1.860	
1984	1.484	0.338	1.822	
1985	1.532	0.253	1.785	
1986	1.580	1.171	1.751	
1987	1.629	0.218	1.848	
1988	1.679	0.264	1.943	
1989	1.729	0.309	2.038	
1990	1.779	0.226	2.005	
1991	1.830	0.145	1.975	
1992	1.881	0.074	1.955	
1993	1.932		1.932	
1994	1.984		1.984	
1995	2.037		2.037	

* As of June 30, 1963.

In summary, according to the FSLIC projections in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured institutions by 1970, and all section 1727(d) payments, together with all amounts credited thereon, would be consumed in discharging the obligation of insured institutions to pay regular insurance premiums by the time that the Primary Reserve itself reaches the two percent level in 1995.

During the years 1962 through 1967, petitioner received annual "Insurance Premium Notices" from the FSLIC charging it with "Annual Premium[s] at rate of 1/12 of 1%" (of its insured accounts and creditor obligations) in the following amounts:

Year:	*Premiums*
1962	$ 93,258.58
1963	135,760.52
1964	196,413.86
1965	271,477.00
1966	317,427.60
1967	373,025.38

All such sums were paid by petitioner to the FSLIC in the year assessed.

During each of those same years, petitioner also received from the FSLIC a separate "Notice of Insurance Premium Prepayment," which set forth the amounts due from petitioner, and the manner in which computed, generally as follows:

Year	Increase in accounts of petitioner's insured members (depositors) during preceding year	Gross prepayment (2% of increase in prior year)	FHL bank stock credit	Net amount due June 1
1962	$ 6,337,974	$ 126,759.48	0	$ 126,759.48
1963	44,131,843	882,636.86	0	882,636.86
1964	61,746,484	1,234,929.68	$784,100.00	450,829.68
1965	71,489,450	1,429,789.00	334,700.00	1,095,089.00
1966	61,303,238	1,226,064.76	0	1,226,064.76
1967	(1,944,138)	0	0	0

All such section 1727(d) payments billed to petitioner were paid by it to the FSLIC in the year due.

All section 1727(d) payments have been credited on the books and records of the FSLIC directly to its "Secondary Reserve." Effective with the first of such payments, the FSLIC has maintained separate accounts for each insured institution and annually forwards statements to such institutions showing, among other things, the total amount of section 1727(d) payments made to that time, the interest credited annually by the FSLIC to the account pursuant to section 1727(e), and the insured institution's pro rata share of the Secondary Reserve. Petitioner's account, No. 2066, reflects the following:

Date	Sec. 1727(d) payment	Annual return		Pro rata share of secondary reserve		
		Rate	Amount	Debit	Credit	Balance
May 31, 1962	$ 126,759.48				$ 126,759.48	$ 126,759.48
Dec. 31, 1962		3.151433%	$ 2,342.10		2,342.10	129,101.58
May 31, 1963	882,636.86				882,636.86	1,011,738.44
Dec. 31, 1963		3.549594%	22,951.42		22,951.42	1,034,689.86
May 28, 1964	450,829.68				450,829.68	1,485,519.54
Dec. 31, 1964		(1)	44,864.25		44,864.25	1,530,383.79
June 1, 1965	1,095,089.00				1,095,089.00	2,625,472.79
Dec. 31, 1965		3.555086%	77,231.97		77,231.97	2,702,704.76
June 1, 1966	1,226,064.76				1,226,064.76	3,928,769.52
Dec. 31, 1966		3.837323%	131,295.86		131,295.86	4,060,065.38
June 1, 1967	0				0	4,060,065.38
Dec. 31, 1967		4.232271%	171,832.97		171,832.97	4,231,898.35
Dec. 31, 1967					[2]690,217.11	4,922,115.46

[1] Not in record.

[2] Transferred from the account of another savings and loan association due to merger.

Section 8701 of the California Financial Code authorizes the Savings and Loan Commissioner to establish a uniform classification of accounts for savings and loan associations and to prescribe the manner in which such accounts are to be kept. On May 21, 1962, the California Savings and Loan Commissioner issued an order prescribing the procedure for accounting for section 1727(d) payments, which order was modified and incorporated into the "Uniform Classification of Accounts" effective January 1, 1963, and, as modified, has remained effective for all subsequent periods. The "Uniform Classification of Accounts" requires each California savings and loan association to treat section 1727(d) payments as an asset,

in an account entitled "Contributions to Secondary Reserve—FSLIC;" to treat the return credited to its pro rata share of the Secondary Reserve as income when notified by the FSLIC that such return has been credited to its account; and to treat transfers made from its pro rata share of the Secondary Reserve to discharge its obligation to pay regular annual premiums as expenses when notified of such transfer.

On petitioner's balance sheet for the year 1962, its section 1727(d) payment for that year, and the statutory interest credited thereon, were included in "Other Assets;" beginning in 1963, all section 1727(d) payments have been shown, on the asset side of the balance sheet, as "Prepaid Federal Savings and Loan Insurance Corporation Premiums." Such payments were not included as an expense on any of its income statements for the periods 1962 through 1966. The interest credited to petitioner's account pursuant to section 1727(e) by the FSLIC for each of the years 1962 through 1966 was included in miscellaneous income for the year in which the interest was credited to petitioner's account by the FSLIC. These items were similarly treated on the Consolidated Financial Statements of petitioner's parents, First Lincoln Financial Corporation, and its subsidiaries. All of petitioner's financial statements for the years 1962 through 1966, and all consolidated financial statements of its parent for those years, were audited by the firm of Peat, Marwick, Mitchell & Co., certified public accountants, which submitted accompanying "Accountant's Reports" stating that the financial position of petitioner (or its parent) had been presented fairly therein, "in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

The regulations of the FHLB Board require each savings and loan association which is a member of the Federal Home Loan Bank system to file, on forms provided by the Board, a semi-annual report of its affairs as of the end of each semiannual period. Printed instructions for the preparation of such reports are published and distributed to each member. The "Introduction" to these instructions states that: "These instructions are provided

to assist in the completion of monthly and semiannual reports by members of the Federal Home Loan Bank System. Each reporting institution is urged to carefully follow these instructions * * *." Under the heading "Schedule D, Other Assets," each institution insured by the FSLIC is instructed to report in that category "the amount of its pro rata share in the Secondary Reserve established by the Corporation from the premium prepayments." In all of its reports to the FHLB since 1962 petitioner has reported its pro rata share of the Secondary Reserve as an asset under the heading "Other Assets," as required by such instructions.

On its Federal income tax returns for the years 1962, 1963 and 1964, petitioner deducted both its section 1727 (b) (1) regular premium payments and its section 1727 (d) payments under "other deductions" as "Federal insurance premiums." Upon examination of its returns for those years, the Commissioner allowed the deduction for amounts paid under section 1727(b)(1), but disallowed a deduction for all section 1727(d) payments. In its petition to this Court, petitioner put in issue the greater part of the deficiency in its income tax as determined by the Commissioner with respect to the calendar year 1963.[3] It concedes the correctness of all the adjustments made by the Commissioner for 1963 with the exception of his disallowance of a deduction of $882,636.86, the amount of the section 1727(d) payment made by petitioner in that year.

OPINION

RAUM, *Judge*: Petitioner, a savings and loan association licensed by the State of California and doing business in the Los Angeles area, has since 1938 insured the savings accounts of its depositors with the Federal Savings and Loan Insurance Corporation (the "FSLIC"), pursuant to the provisions of Title IV of the National Housing Act, as amended. (12 U.S.C. sec. 1724 *et seq.*) It pays an annual "premium for such insurance" in an amount equal to 1/12 of one percent of the total amount

[3] There was no deficiency in petitioner's income tax in the other years.

of all its savings accounts and creditor obligations, as provided in section 1727(b)(1). Since 1962, as the result of amendments made to the National Housing Act, petitioner has been required to make further annual payments to the FSLIC under section 1727(d), hereinafter sometimes referred to as "Sec. 1727(d) payments", equal to two percent of any net increase in its insured accounts during the previous year, but reduced in the case of an insured institution, such as petitioner, which is also a member of a Federal Home Loan Bank, by the amount of any required purchase of stock in such Bank for that year. These section 1727(d) payments are described in the statute as "additional premium[s] in the nature of * * * prepayment[s] with respect to future premiums." In 1963, the only year here in issue, petitioner paid its annual insurance premium for the year in the amount of $135,760.52, and made its section 1727(d) payment in the amount of $882,636.86. Both sums were deducted on its 1963 Federal income tax return as "Federal insurance premiums." The Commissioner, while not disputing petitioner's right to deduct its regular annual insurance premium, disallowed in full the deduction of $882,636.86 claimed for the additional section 1727(d) payment. The sole issue for decision is whether this latter payment was an ordinary and necessary expense of petitioner's business in 1963, or a capital expenditure deductible, if at all, only in later years to the extent that it ceased to be an asset of petitioner.

Although described in the statute as "an additional premium in the nature of a prepayment with respect to future premiums," the section 1727(d) payment is neither an "additional premium," in the sense of being a mere increase in the annual insurance premium as contended by petitioner, nor a "prepayment with respect to future premiums," at least insofar as the ordinary prepaid insurance premium is taken as a standard. The National Housing Act is not, of course, a revenue statute, and the label attached to section 1727(d) payments therein is not, and was not intended to be, conclusive in the determination of how these payments should be treated for Federal tax purposes. See *McMillan Mortgage Company*, 36 T.C. 924,

928. The label is at any rate ambiguous, though if we were to give it binding effect here, we should most certainly adopt the characterization of "prepayment" as controlling, and would therefore have to deny petitioner a current deduction for its section 1727(d) payment under a long line of decisions by this Court holding that prepaid insurance premiums are capital expenditures to be expensed over the years in which coverage is actually obtained. *Higginbotham-Bailey-Logan Co.*, 8 B.T.A. 566, 577; *George S. Jephson*, 37 B.T.A. 1117, 1119-1120; *Martha R. Peters*, 4 T.C. 1236, 1242; *Louise K. Herter*, 20 T.C.M. 78, 86. See and compare *Commissioner* v. *Boylston Market Ass'n.*, 131 F. 2d 966 (C.A. 1), affirming a Memorandum Opinion of the Board of Tax Appeals, with *Waldheim Realty and Investment Company* v. *Commissioner*, 245 F. 2d 823 (C.A. 8), reversing 25 T.C. 1216. But regardless of whether the section 1727(d) payment may properly be characterized as a prepaid insurance premium, we reach the same ultimate result, for an analysis of the substantive provisions of section 1727 convinces us that this payment, however labeled, is in the nature of a capital outlay and is therefore not deductible as an expense in the year that it is made.

That the section 1727(d) payment is qualitatively different from the regular annual insurance premium payable under section 1727(b)(1), and constitutes something more than a mere increase in the premium rate, seems to us beyond question. Regular annual premiums are part of the gross income of the FSLIC and, along with its income from investments, are used to meet the FSLIC's operating expenses and insurance losses, if any, for the year. To the extent that such premiums are not so used, they are transferred, as part of the FSLIC's net income for the year, to the "Primary Reserve," the FSLIC's general reserve which contains its cumulative net income or "retained earnings" and which is available to meet the FSLIC's insurance losses if its income in any year is insufficient for this purpose. Section 1727(d) payments, on the other hand, are not considered as income by the FSLIC, and are not ordinarily available to meet the annual expenses and losses of the Corporation.

Instead, the FSLIC is required by statute to credit all such payments directly to a "Secondary Reserve," which is to be used "only for losses of the Corporation and shall be so available *only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses.*" Section 1727(e). (Emphasis added.) Thus, instead of being taken into income, freely available to meet expenses and losses of the current year, the section 1727(d) payment is credited directly to an account, rather like a capital account, which may be applied against losses only in the event that the regular insurance premiums for the year, the corporation's other income, and its retained earnings of prior years have all been depleted. It cannot, therefore, be accurately termed a premium for insurance coverage in the year of payment, but, at least initially, is in reality a capital investment in the FSLIC, part of a pool or capital available to the FSLIC for the payment of losses in the event of emergency.

Furthermore, when the regular insurance premiums paid by insured institutions under section 1727(b)(1) are received by the FSLIC, they lose their distinctive character as premiums and become merely part of the gross income of the corporation; the insured institution retains no rights in respect of such sums, other than the right to insurance coverage for the current year, and its premium, once paid, is lost to it forever. Payments made under section 1727(d), however, stand on quite a different footing. Such payments, as noted above, are immediately segregated in the "Secondary Reserve," and the FSLIC is directed by statute to credit the outstanding balance in this account, on an annual basis, with a "return" computed "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Section 1727(e). What is more, each insured institution maintains an interest in a pro-rata share of the Secondary Reserve, and is annually furnished with a statement of its account by the FSLIC, which keeps a separate account for each insured institution. That annual

statement discloses all section 1727(d) payments made by the insured institution, the interest or return earned by the account, any debits that may have been charged against the account, and, finally, the new balance in the account as of the end of the year. Thus, for the years 1962-1967, petitioner's account, set forth in our findings, reflects various credits (section 1727(d) payments and interest or return), no debits, and a balance of $4,922,115.46 in its favor, representing its pro rata share in the Secondary Reserve as of December 31, 1967.

While petitioner's pro rata share of the Secondary Reserve is not, as a general rule, assignable or transferable, "by operation of law or otherwise," the value of such share may be fully realized through its transfer to another insured institution in a merger, consolidation or bulk sale; petitioner may even receive the value of its share from the FSLIC in cash if (1) its insured status is terminated, either voluntarily or involuntarily, (2) it goes into liquidation, voluntarily are involuntarily, or (3) the obligation to make section 1727(d) payments is permanently terminated and the Secondary Reserve distributed before the value of its share has otherwise been fully recovered. See p. ——, *infra*. Moreover, assuming petitioner does not realize the value of its pro rata share in one of the above ways, it is reasonably assured of receiving full value therefor in the form of insurance coverage in future years when its share of the Secondary Reserve is used to pay its regular section 1727(b)(1) premiums. To the extent that the petitioner's share is so used, entries will undoubtedly be made in the debit column of its account which will be reflected in the balance appearing as of the end of each such year. Also, to the extent that any losses may be charged in any year against the Secondary Reserve, petitioner's pro rata share thereof should similarly appear in the debit column, thereby also adversely affecting its balance as of the end of such year. And to the extent that any such debits are charged against petitioner's balance in any particular year, whether for regular section 1727(b)(1) premiums or for losses, it would seem that petitioner would be entitled to deductions in those amounts for any such year. Cf. Rev. Rul. 66-49, 1966-1 C.B. 36, 37.

As already noted, the Secondary Reserve is available for the payment of losses, but only to a very limited extent. It has, however, never been used for this purpose, nor, on the basis of the FSLIC's past loss experience, does such use appear to be likely. At the time that Congress considered Public Law 87-210, in 1961, net insurance losses of the FSLIC had absorbed only 1.1 percent of its gross income over its entire existence, H. Rept. No. 823, 87th Cong. 1st Sess. p. 2 (1961); S. Rept. No. 778, 87th Cong. 1st Sess. p. 2, and the financial statements of the FSLIC put in evidence by the parties, covering all the years thereafter through December 31, 1967, reveal no year in which the net insurance losses of the FSLIC exceeded even its investment income, much less the annual premiums for the year and/or the Primary Reserve, both of which must be fully consumed before the Secondary Reserve can be utilized. The Primary Reserve alone stood at $921,669,395 on December 31, 1967, while the *cumulative* net losses of the FSLIC from June 27, 1934 through December 31, 1967, totalled only $105,610,365. Of course, an event of catastrophic proportions, another Great Depression, could conceivably wipe out the Secondary Reserve, but the probability that such an event will occur is simply incalculable. It is certainly not an event that could reasonably be anticipated as of any particular time, and if any event should occur requiring a charge against the Secondary Reserve in respect of any loss, petitioner's pro rata share thereof would then be deductible, as has already been pointed out. But there do not appear to be any greater hazards in this respect than attach to the capital investment made by a stockholder in a commercial bank or an insurance company.

Though it is clear that "prepayments" under section 1727(d) are not really insurance premiums, at least not in the year in which they are paid, a further examination of the provisions of Public Law 87-210 also reveals sharp differences between such "prepayments" and the ordinary prepaid insurance premium. While the average prepaid insurance premium gives rise to an obligation on the part of the insurer to provide coverage for some definitely ascertainable period of time, usually not more

than two or three years from the date of the policy, the FSLIC incurs no such obligation upon its receipt of a section 1727(d) payment. The obligation to provide insurance coverage does not arise until the section 1727(d) payment is actually used to discharge the obligation of the insured institution to pay a regular section 1727(b)(1) insurance premium, which event is contingent upon the ratio of the FSLIC's reserves to its potential liabilities attaining certain levels. Moreover, since the section 1727(d) payment credited to the Secondary Reserve is subject to accretion through the annual "return" credited annually by the FSLIC on the outstanding balance in such reserve, and at least theoretically to depletion in the event the reserve is used to meet losses in an emergency situation, and since the regular annual premium required by section 1727(b)(1) is itself a percentage of the insured institution's accounts and creditor obligations, and thus varies from year to year, there is no way of predicting with certainty the number of years of insurance coverage which will be procured by each section 1727(d) payment, much less the precise years which will be covered. Thus, unlike the common prepaid insurance premium, the section 1727(d) payment is not simply "an exhaustible asset with a determinable life" whose value may be allocated "ratably over the term for which the premium is paid," see *George S. Jephson*, *supra*, 37 B.T.A. 1117, 1120; *Higginbotham-Bailey-Logan Co.*, *supra*, 8 B.T.A. 566, 577, the life of the asset created by the section 1727(d) payment is not determinable on the date of payment, and its usefulness will not be ratably spread over the period of that life.

For the period of time prior to its use to discharge the obligation of the payor institution to pay regular annual premiums required by section 1727(b)(1), the section 1727(d) payment will simply constitute part of the capital of the FSLIC. Under the terms of the statute, section 1727(g), the pro rata share of each insured institution in the Secondary Reserve will be used to pay its regular annual premiums, and the obligation of insured institutions to make section 1727(d) payments will concurrently be suspended, only after the aggregate of the FSLIC's

Primary and Secondary Reserves equals or exceeds two percent of the total amount of all savings accounts and creditor obligations of institutions insured by the FSLIC. The obligation to make section 1727(d) payments will, however, resume, if the aggregate of the two reserves subsequently falls below 1¾ percent of the FSLIC's potential liabilities, and, until such aggregate again reaches the two percent level, the use of the pro rata share of each insured institution to pay its regular annual premiums must also cease. It is not until the FSLIC's Primary Reserve alone equals or exceeds two percent of its potential liabilities that the obligation to make section 1727(d) payments will permanently terminate, at which time insured institutions are entitled to the refund of their pro rata share of any amount remaining in the Secondary Reserve. Clearly then, the effect of these provisions is to require insured institutions to make and keep capital investments in the FSLIC, until it has retained enough of its own earnings (in the Primary Reserve) to provide in the opinion of Congress, adequate protection for insured savers.

To be sure, the asset acquired by petitioner by virtue of its section 1727(d) payments, i.e., its pro rata share of the FSLIC's Secondary Reserve, differs in many respects from the usual capital investment. Petitioner is required by law to make the investment, at least as long as it wishes to insure its accounts with the FSLIC, cf. *Hotel Sulgrave, Inc.*, 21 T.C. 619, the amount of the investment is determined by the growth of its business, i.e., the increase in its savings accounts, and the asset so acquired is ordinarily not transferable to others. But these differences, though perhaps not insignificant for other than tax purposes, cannot alter the fact that the section 1727(d) payment does not actually provide insurance coverage for petitioner in the year of payment, and is not an ordinary and necessary expense of that year; it results in the acquisition of an asset which, if held to "maturity" and not transferred in a merger, consolidation or bulk sale, and not refunded in the event of a termination of insurance or liquidation, will result in benefits, in the form of insurance coverage, in future years. In these

circumstances, it is a matter of no consequence whether petitioner is a cash or accrual basis taxpayer, for the rule is the same for both that: "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made." Regs. sec. 1.461-1(a)(1) and (2). Moreover, we need not look far to find a similar investment which, though possessing many of these same peculiar attributes, is nevertheless a capital expenditure. An example readily at hand lies in the payment by petitioner of amounts required by section 6 of the Federal Home Loan Bank Act, 12 U.S.C., section 1426(c), for the acquisition of capital stock in its Federal Home Loan Bank, a payment which we think is closely analogous to the section 1727(d) payment here, and which petitioner has consistently capitalized rather than expensed in the year of payment.

Membership in a Federal Home Loan Bank entitles a savings and loan association to obtain advances from such Bank, up to certain limits, upon the security of its home mortgages and obligations of or guaranteed by the United States, 12 U.S.C. section 1430(a); it thus serves the important function of providing members with a source of additional liquidity and funds for mortgage lending. As a condition of membership, the savings and loan association must initially purchase stock in one of twelve regional Home Loan Banks, depending upon the district in which it is located, equal to one percent of such association's "aggregate unpaid loan principal," [4] and must purchase such additional amounts of stock thereafter as is necessary to maintain this ratio at the close of each succeeding calendar year. 12 U.S.C. sec. 1426(c)(1). Amounts so invested are not ordinarily transferable, and, in general, are returnable to the member only upon its withdrawal from membership. Also, if at the time of withdrawal the FHLB Board finds that the paid-in capital of the member's Federal Home Loan Bank is or is likely to be

[4] Defined as the aggregate unpaid principal of its home mortgage loans, home-purchase contracts, and similar obligations. 12 U.S.C. sec. 1426(c)(4).

impaired as a result of losses in or depreciation of the assets held by such Federal Home Loan Bank, the amount to be paid the member in retirement of its stock is reduced by its pro rata share of the amount of the impairment. 12 U.S.C. sec. 1426(i). The similarities between the mandatory payments made by petitioner to its Federal Home Loan Bank and those made to the FSLIC are thus strikingly apparent.[5] True, petitioner did not receive any pieces of paper to evidence its pro rata share of the Secondary Reserve, though one could imagine a redeemable preferred stock which incorporated all the provisions of sections 1727(d), (e), (f) and (g) as described above, which might have been issued in exchange for such payments. But it acquired an asset nevertheless, if evidenced only by the annual statements sent to petitioner every year showing the status of such pro rata share. That the section 1727(d) payment made to acquire that asset was mandatory and based upon the volume of petitioner's business, and that the asset itself was nontransferable and subject to a limited extent to the losses

[5] Petitioner argues that the legally compelled investments made in its Federal Home Loan Bank are fundamentally distinguishable from the section 1727(d) payments here by virtue of the fact that it is entitled to dividends on its Federal Home Loan Bank stock which are immediately available for its use, and the further fact that the Federal Home Loan Bank may, "in its discretion," retire the stock of any member to the extent that it exceeds the required ratio. Although these are distinctions, they are nevertheless distinctions without a difference here. We do not consider it significant that petitioner's annual dividends on its Federal Home Loan Bank stock are distributed to it rather than being credited to its account, nor do we think it important that petitioner may receive some of the funds invested in the Federal Home Loan Bank before it begins to receive, actually or constructively, its section 1727(d) payments. Moreover, assuming that it remains a member of both the Federal Home Loan Bank and the FSLIC indefinitely, petitioner will certainly receive its total investment in the FSLIC before it receives the money it has invested in its Federal Home Loan Bank, for while there is a definite limit on petitioner's commitment to the FSLIC, there is none on its commitment of funds to the Federal Home Loan Bank. At any rate, the question of when such investments or the return thereon, will be redeemed is simply a question of timing; the important point is that both are in fact capital investments.

of the corporation in which the funds were invested, does not make it any more an ordinary and necessary expense, nor less a capital expenditure, than the required investments made by petitioner in its Federal Home Loan Bank.

Moreover, the section 1727(d) payments, which are measured by the net increase of the institution's insured accounts during the preceding year, were in fact regarded by Congress, in part at least, as being a substitute for investments in the capital stock of the Federal Home Loan Banks which member institutions were theretofore required to make. A member institution was formerly obligated to purchase and hold such capital stock equal to two percent of its outstanding home mortgage loans, but when its obligation to make the section 1727(d) payments commenced in 1962, the two percent level in respect of the capital stock was simultaneously reduced to one percent. It is clear that Congress regarded these as interrelated events,[6] and in our judgment the 1727(d) payments represented capital outlays by the member institution just as much as its investment in the stock of its regional Federal Home Loan Bank.

The legislative history of Public Law 87-210, which amended section 1727 to its present form in 1961, does not of course deal with the manner in which section 1727(d) payments should be treated for Federal tax purposes, but it is certainly not inconsistent with anything we have said here. The decade preceding the enactment of the bill witnessed a tremendous increase in the growth of institutions insured by the FSLIC, and a concomitant growth in the total amount of savings insured by the Corporation. But, in that same decade, the FSLIC was required by Congress to use its income to retire all of its captal stock, in the amount of $100,000,000, from the United States Treasury. The result was a decline in the ratio of the reserves of the FSLIC to its potential liabilities during this period from 0.843 percent to 0.661 percent. See S. Rept. No. 778, 87th Cong., 1st Sess., pp. 2, 12; Hearings Before Subcommittee No. 1 of the Committee on Banking and Currency, House of Representatives, 87th Cong., 1st Sess., on H.R. 7108 and H.R. 7109, pp. 10, 39.

[6] See *infra*, p. ——.

Public Law 87-210 was "designed to add new strength" to the FSLIC by requiring insured institutions to make so-called "premium prepayments" which, it was hoped, "would result in a marked acceleration in building up the Corporation's reserves." H. Rept. No. 823, 87th Cong., 1st Sess., p. 2 (1961); S. Rept. No. 778, *supra*, pp. 1-2.

Petitioner emphasizes that Congress spoke in terms of building up the FSLIC's *reserves*, that section 1727(d) payments are in fact credited to a "Secondary Reserve," and concludes that a necessary corollary is that payments made to a reserve must be insurance premiums. This is no more than semantic word play. The truth of the matter is that, for the reasons outlined at the beginning of this opinion, section 1727(d) payments cannot be considered merely additional insurance premiums. Had Congress felt that the premium income of the FSLIC was inadequate to meet expenses and losses, it could easily have increased the regular annual premium to what it considered a more realistic level, without enacting all the complicated provisions which govern section 1727(d) payments. But, in fact, during the entire life of the corporation its total expenses had, to 1961, amounted to only 3.7 percent of its gross income while net insurance losses had absorbed "a mere 1.1 percent of the gross income." Hearings, *supra*. p. 10. Cf. H. Rept. No. 823, *supra*, p. 2, S. Rept. No. 778, *supra*, p. 2. What was needed was additional capital, not additional premium income, which would serve as a buffer until the FSLIC had accumulated enough of its own income to bring its "Primary Reserves," the true insurance reserve, to the desired two percent level.[7] True, Congress called the ac-

[7] Compare the statement of Everett C. Sherbourne, vice-chairman, Federal Legislation Committee, National League of Insured Savings Associations, Hearings, *supra* p. 45. "From the standpoint of the loss experience of the Corporation, we do not believe the reserve would be inadequate * * *. There is, however, an inadequacy of working capital." This witness went on to explain that the FSLIC does not "sit idly by, wait for a loss to occur, and then pay out insurance * * *", but has authority to take steps, such as the making of loans to institutions in danger of failing, which "may involve substantial cash disbursements without ultimate loss to the Corporation."

The savings and loan industry supported Public Law 87-210, see S. Rept. No. 778, 87th Cong., 1st Sess., pp. 5, 12-13, in line with

count to which this additional capital was credited a "Secondary Reserve," but since such "reserve" served the same function as a capital account, and was available for losses "only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses," Congress' use of the terminology of the insurance industry should not confuse the issue. And what, after all, is the capital account of any corporation if not a "Secondary Reserve," a pool of capital available to creditors in the event that the corporation's current income and retained earnings are not sufficient to satisfy their claims?

As has previously been pointed out, at the same time and in the same measure directing insured institutions to make these additional section 1727(d) payments to the FSLIC, Congress reduced the ratio of stock which members of a Federal Home Loan Bank were required to hold against their "unpaid loan principal" from two to one percent. It was contemplated that "[f]or most institution, this prepayment requirement [i.e., section 1727(d) payments] would be approximately offset by reducing the stock the institution must purchase in its Federal home loan bank." See H. Rept. No. 823, *supra*, p. 2; S. Rept. No. 778, *supra*, pp. 1-2. In essence, then, Public Law 87-210 provided that funds which would otherwise have gone into the capital structure of the Federal Home Loan Banks, which already had "more than sufficient [amounts invested in capital stock] to meet the criterion of adequate capitalization," see Hearings, *supra*, p. 9, would be channeled instead to the FSLIC's Secondary Reserve, which is itself essentially a capital account, though more temporary in nature. Moreover, to the extent that an insured institution is required to purchase additional stock in its Federal Home Loan Bank, its section 1727(d) payment to the FSLIC is reduced by the amount of stock so purchased. Clearly, if the section 1727(d) payments represented actual insurance premiums needed by the

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its "longstanding position" that savings and loan associations should finance "their Insurance Corporation" rather than "rely on taxpayer funds for this purpose." See S. Rept. No. 378, 89th Cong., 1st Sess., pp. 71-72 (1965).

FSLIC to meet its expenses and losses, rather than merely a capital cushion for the FSLIC, this arrangement would not have been feasible. The fungibility of capital stock payments to the Federal Home Loan Bank and section 1727(d) payments to the FSLIC under Public Law 87-210 strongly suggests that Congress thought of both as serving roughly the same purpose.

The conclusion then, is inescapable that section 1727 (d) payments result in the creation of an asset in the nature of a capital investment which should, however, eventually be used to provide insurance coverage in future years, and that for Federal income tax purposes at least, such payments must be capitalized and deducted from gross income only in the years and to the extent actually used to provide such insurance coverage or actually drawn upon to meet losses. Regs. section 1.461-1 (a), *supra*. Nor are we convinced by petitioner's argument and the testimony of its expert witnesses, that even as a matter of general accounting practice a section 1727(d) payment should be written off immediately because of uncertainty as to whether and when it will benefit the insured institution. We have already demonstrated that, for all practical purposes, these payments will definitely be used to discharge the obligation of the insured institution to pay regular annual premiums in future years, assuming it has not previously transferred its pro rata share of the Secondary Reserve or received a cash payment in respect thereof from the FSLIC. Even the years in which the Secondary Reserve will be available for such use are not wholly a matter of conjecture, for the Office of the Comptroller of the FSLIC has made projections in this regard, showing, inter alia, that the aggregate of the Primary and Secondary Reserves of the FSLIC will equal or exceed two percent of the FSLIC's potential liabilities by 1970, and will thereafter be available for payment of regular annual premiums in subsequent years (except those in which the aggregate of the reserves falls below 1¾ percent of the FSLIC's potential liabilities, as disclosed in the projection) until 1995, when the Primary Reserve is expected to equal or exceed the

two percent ratio by itself.[8] See Findings of Fact, p. —, *supra*.

Moreover, the fact of the matter is that both the California Savings and Loan Commissioner and the FHLB Board require that section 1727(d) payments be capitalized and shown on the financial statements of insured institutions as an asset, to be expensed only in the years in which actually used to satisfy the insured institution's obligation to pay a regular section 1727(b) insurance premium. It is, of course, well established that methods of accounting prescribed by regulatory agencies are not controlling for Federal tax purposes. *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 562; *Bellefontaine Federal Savings and Loan Association*, 33 T.C. 808, 811-812, but where, as here, the accounting treatment prescribed for a particular expenditure appears to be prompted not by any particular statutory or regulatory requirements (indeed, it would seem that agencies charged with the supervision of financial institutions would be quite anxious that the assets and net income of such institutions not be overstated) but rather to be based upon sound accounting principles, it should not be wholly disregarded. Furthermore, the financial statements of both petitioner and its parent, the First Lincoln Financial Corporation reported the section 1727(d) payments here in issue as assets, not expenses, and the firm of certified public accountants which audited such financial statements was able to state, in the Accountant's Report preceding such financial statements, that they presented fairly the financial position of

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[8] The projections made by the FSLIC are, of course, based on a number of assumptions, and are not infallible. Still, they have been proven relatively accurate for the first five years since the enactment of Public Law 87-210, and, in its annual report for 1966, the FHLB Board (which administers the FSLIC) stated that it expected the aggregate of the Primary and Secondary Reserves to reach the two percent level by 1971, as compared to the prediction of 1970 in the original FSLIC estimate. To be sure, these estimates will not allow an insured institution to compute with pinpoint accuracy the years in which its section 1727(d) payments will be used to provide insurance coverage, but they do at least allow it to make a rough approximation.

petitioner and its parent "in conformity with generally accepted accounting principles * * *."

We are aware that the same issue that confronts us here was raised, and recently decided in favor of the taxpayer, in *First Federal Savings & Loan Ass'n of St. Joseph* v. *United States*, 22 AFTR 2d 5238 (W.D. Mo. 1968),[9] the only case in which the issue herein has been adjudicated. The District Court there refused to follow Rev. Rul. 66-49, 1966-1 C.B. 36, in which it was stated that section 1727(d) payments were not deductible as ordinary and necessary expenses. The court held that section 1727(d) payments were deductible in the year of payment, relying on the fact that insured institutions are "subject to the basic liability" to make such payments, that the funds were "paid with respect to insurance coverage and * * * [were] based, to a certain extent, upon the risk of loss," and "of even more significance," upon the fact that such payments "were subject to being completely consumed in the event of a loss." We have already expressed our opinion on these matters, and, being of the view that section 1727(d) payments are nondeductible capital expenditures, we respectfully decline to follow the holding of the District Court. Though we prefer to rest our holding upon the reasons set forth in this opinion, we do agree with the conclusion reached in Rev. Rul. 66-49 that section 1727(d) payments are not ordinary and necessary expenses in the year of payment and are not deductible until they are used to pay regular premiums or losses, or the possibility of their return to the institutions

[9] That case involved a Federal savings and loan association which, unlike petitioner, a state-chartered association, was required and not merely permitted to insure its accounts with the FSLIC. Thus, it did not have the option, available to petitioner, of terminating its insured status without going into liquidation, while petitioner, theoretically at least, could cease being an insured institution of the FSLIC, receive its pro rata share of the Secondary Reserve in cash, and still remain in business. We need not discuss further whether this alternative was open to petitioner as a practical matter, and do not express any opinion as to the significance of this distinction, for our disagreement with the District Court's opinion goes to the more basic issue of the inherent nature of the section 1727(d) payment.

is otherwise precluded. Rev. Rul. 66-49, *supra*, 1966-1 C.B. 36, 37.[10]

Because of the unusual nature of the section 1727(d) payments in issue, the remaining cases and rulings cited by both petitioner and respondent are, for the most part, distinguishable on their facts. Thus, cases cited by petitioner for the proposition that an ordinary and necessary business expense is not rendered nondeductible because there remains after payment a contingent possibility of future recovery, e.g., *Alleghany Corporation*, 28 T.C. 298, 305; *Electric Tachometer Corp.*, 37 T.C. 158; and cf. I.T. 2764, XIII-1 C.B. 45, IT. 3632, 1943 C.B. 114,[11] Rev. Rul. 62, 1953-1 C.B. 71, are of no help to petitioner here since it failed to establish the necessary initial foundation required by these cases; i.e., that the amount of $882,636.86 paid by it to the FSLIC in 1963 pursuant to section 1727(d) constituted an ordinary and necessary expense of that year. Cf. *Harry W. Williamson*, 37 T.C. 941, 944. Nor, on the other hand, were these payments

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[10] It was also held in Rev. Rul. 66-49 that the annual return credited to each insured institution on amounts in its pro rata share of the Secondary Reserve does not constitute taxable income to an insured institution on the cash basis until actually or constructively received by it, either by way of refund or by its use to discharge the insured institution's obligation to pay annual premiums. Petitioner, while of course not disparaging the Commissioner's position on this matter, claims it is inconsistent with his position on the deductibility of the section 1727(d) payments. The question of when this annual "return" must be included in the income of a cash basis taxpayer is not now before us, and we express no opinion thereon. We do note, however, that the position we take here, that section 1727(d) payments are nondeductible capital expenditures, is not inconsistent with the Commissioner's position as to the time for inclusion of the annual return on income.

[11] I.T. 2764, relied upon by petitioner, was declared obsolete in Rev. Rul. 68-100, 1968-9 I.R.B. 24. It involved payments made to a temporary insurance fund set up by the Federal Deposit Insurance Corporation in the first days of its creation, and relied upon G.C.M. 8474, IX-2 C.B. 281, which was shortly thereafter revoked by the Commissioner. G.C.M. 13290, XIII-2 C.B. 313. See text concerning the Texas State Depositor's Guaranty Fund, p. ——, *infra*. I.T. 3632, another ruling cited above upon which petitioner relies, cited as its only authority I.T. 2764. Both I.T. 2764 and I.T. 3632, however, are also distinguishable on their facts, as is noted above.

merely security deposits in the nat ature of a reserve for
contingent liabilities as suggested d by respondent. Cf.
Spring Canyon Coal Co. v. *Commi nissioner*, 43 F. 2d 78
(C.A. 10), certiorari denied 284 U U.S. 654; *Wayne Title*
& Trust Co. v. *Commissioner*, 195 ; F. 2d 401 (C.A. 3);
Wolfington Body Co. v. *Smith*, 99 9 F. Supp. 788 (E.D.
Pa.). Compare *Weber Paper Compo pany* v. *United States*,
204 F. Supp. 394 (W.D. Mo.) affir firmed, 320 F. 2d 199
(C.A. 8), with Rev. Rul. 60-275, 19(960-2 C.B. 43. Perhaps
most closely approximating the situ uation in this case are
those cases and rulings involving pay ayments made by Texas
State banks during the 1920's to) the Texas State De-
Depositor's Guaranty Fund, which, be because they shed some
light on the section 1727(d) paym ments involved herein,
we now set forth in some detail.

Texas statutes required every sta tate bank to protect its
depositors either by a bond or polic licy of insurance, or by
becoming a contributor to the Deposi sitor's Guaranty Fund.
If the latter method was elected, the ne bank was required to
make annual contributions to the e Fund based upon its
average deposits, one-fourth in cash h to the State Treasury
on which the bank was entitled to int nterest, though not pay-
able until its liquidation or withdr drawal from the Fund,
and three-fourths as a deposit on i its books to the credit
of the State Banking Board. Thes nese "regular contribu-
tions" were to continue until the Fu Fund contained five mil-
lion dollars. If a contributing bank f failed, whatever money
was needed to pay its depositors s was taken from the
Fund, which was then immediately ly reimbursed by a spe-
cial cash assessment levied on the the contributing banks.
Such "special assessments" could not ot exceed two percent of
a bank's total average daily depos posits in any one year,
so that, in any year in which losses es exceeded this amount,
recourse was had to the Fund its itself, and the "regular
contributions" to the Fund would d resume until it again
reached five million dollars. Each ch participating bank's
pro rata share of the Fund was ret returnable to it upon its
withdrawal from the Fund or upor pon its liquidation.

The proper treatment to be acco corded the regular con-
tributions to the Fund for Federal ral income tax purposes
became a matter of some controv roversy. The Bureau of

Internal Revenue first held that they were deductible as "necessary business expenses," I.T. 1258, I-1 C.B. 281, but soon revoked this ruling in I.T. 2208, IV-2 C.B. 81. The position was then taken that the contributions were not deductible since they "remain assets of such participating banks. Each participating bank retains at all times an interest in the fund equal to the unexpended portion of its contributions thereto, the amount whereof is readily determinable * * *". S.M. 3877, IV-2 C.B. 79. The Board of Tax Appeals did not agree with this approach, holding in *First State Bank of Bracketville*, 9 B.T.A. 975, followed in *First State Bank of Weimar*, 10 B.T.A. 396, that such contributions were deductible since they were paid "pursuant to a definite liability fixed by law." *First State Bank of Bracketville*, 9 B.T.A. 975, 980. The Bureau thereupon modified its position to conform to that of the Board of Tax Appeals. G.C.M. 8474, IX-2 C.B. 281.

However, the Board was again confronted with this issue in *Wichita State Bank & Trust Co.*, 27 B.T.A. 822. In that case, the taxpayer bank had withdrawn from the Fund and had received its pro rata portion thereof, and the issue raised was whether such amount was includible in its income. The Commissioner said it was, relying on his newly revised position on this matter following the *Bracketville* and *Weimar* cases, contending that since the regular contributions to the fund were deductible, their return to the taxpayer constituted taxable income. The Board, following its prior decisions, agreed. On appeal, in an opinion which we now think correctly disposed of this matter, the Fifth Circuit reversed the Board on this issue, holding that the regular contributions were not ordinary and necessary expenses but nondeductible capital expenditures. *Wichita State Bank & Trust Co.* v. *Commissioner*, 69 F. 2d 595 (C.A. 5). Keeping in mind the similar characteristics of these "regular contributions" and the section 1727(d) payments here in issue, the following comments of the Fifth Circuit are instructive (69 F. 2d at 596):

> * * * That fund [i.e., the permanent five million dollar Guaranty Fund] is not intended to be lost or consumed, but is to stand as a reservoir drawn on

> to provide prompt payment to depositors, but to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. * * * We think the contributions to the $5,000,000 Guaranty Fund, while made annually instead of in a lump sum, were essentially capital investments and ought to be dealt with as such.

Here the matter of the "regular contributions" was finally settled, the Commissioner indicating agreement with the Fifth Circuit's opinion by reinstating S.M. 3877. G.C.M. 13290, XIII-2 C.B. 313.

We hold that the section 1727(d) payment of $882,-636.86 made by petitioner in 1963 was a nondeductible capital expenditure, that the Commissioner correctly disallowed a deduction for this sum, and that the deficiency determined in petitioner's income tax for 1963 in respect of that disallowance was proper.

Petitioner has made an alternative argument that the Commissioner's attempt to assess and collect the deficiency here violated its constitutional rights under either Article II, section 3 (directing the President to "take care that the laws be faithfully executed") or the Fifth Amendment to the Constitution (the due process clause). Petitioner relies on the fact that in the *First Federal Savings & Loan Ass'n of St. Joseph* case, discussed above, a tax refund suit in which the taxpayer savings and loan association sued to recover taxes which it alleged were erroneously paid for 1963, 1964 and 1965 due to its failure to deduct section 1727(d) payments made in those years, the Government tried to settle by offering to pay the amount sought by the taxpayer and to dismiss the action with prejudice, though it did not wish the terms of the settlement to be included in the final stipulation. It should be noted that the taxpayer refused this offer, and the District Court went to extraordinary lengths in ruling that the refund suit had not become moot. The District Court thereupon adjudicated the issue on the merits in the taxpayer's favor. Petitioner nevertheless contends that the mere fact that the offer of settlement

was made to the taxpayer in the *St. Joseph* case is fatal to the determination of the deficiency herein on Constitional grounds. We think that the point is without merit.

The position taken by the Commissioner in this case in respect of section 1727(d) payments made to the FSLIC is the same as that in Rev. Rul. 66-49, published in Cumulative Bulletin 1966-1, p. 36. We have carefully examined that position, as it relates to the facts of this case, and have found the deficiency determined by the Commissioner in petitioner's income tax for 1963 was justified by the provisions of the Internal Revenue Code of 1954. We cannot and will not go further and examine the Commissioner's reasons and motives for determining the deficiency in this case and defending his position in response to the petition for a redetermination filed by petitioner in this Court. See *Charles Crowther*, 28 T.C. 1293, 1301, affirmed 269 F. 2d 292, 293 (C.A. 9). Petitioner has no ground to object merely because some other taxpayer may have been offered a windfall as a result of the Government's litigation strategy. Whatever may have been the Government's litigation strategy in attempting to dispose of the *St. Joseph* case, it is not a matter about which the petitioner herein has any standing to complain. The history of litigation over the years has been marked by efforts of private litigants as well as the Government to select test cases in such manner as may be thought to further their respective best interests, and the refusal to press some other case has never been thought to create any rights in favor of parties to a case where similar concessions have not been made. Petitioner has been accorded due process of law in the review of the deficiency determined against it by the Commissioner herein and the fact that it has not been offered a windfall, if indeed the offer of settlement in the *St. Joseph* case was such, does not rise to the level of an infringement of its constitutional rights.

Reviewed by the Court.

Decision will be entered for the respondent.

TAX COURT OF THE UNITED STATES
WASHINGTON

[Caption Omitted]

DECISION

(Entered October 21, 1968)

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion, filed October 21, 1968, it is

ORDERED AND DECIDED: That there is a deficiency in income tax for the year 1963 in the amount of $461,454.38.

/s/ ARNOLD RAUM
Judge

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 23,923

LINCOLN SAVINGS AND LOAN ASSOCIATION, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

February 3, 1970

On Appeal from the Decision of the Tax Court of the United States

Before ELY and HUFSTEDLER, *Circuit Judges*, and THOMPSON,* *District Judge.*

THOMPSON, *District Judge:*

We are asked to review a determination by the Tax Court. A deduction of $882,636.86 from Appellant's gross income for 1963 was contested. The Tax Court held that Appellant's payment, made for inclusion in the Secondary Reserve Account of the Federal Savings and Loan Insurance Corporation (FSLIC) resulted in the acquisition of a capital asset rather than constituting an ordinary and necessary business expense deductible in the year paid as contemplated by 26 U.S.C. § 162(a).

Jurisdiction and scope of review are governed by 26 U.S.C. § 7482.

The Tax Court, in its published opinion, Lincoln Savings and Loan Association, Petitioner v. Commissioner of Internal Revenue, Respondent, Docket No. 325-67, 51 T.C. 82, made a comprehensive and accurate statement of the facts. Also in that opinion, as well as in *First Federal Savings and Loan Association of St. Joseph* v. *United States*, 288 F. Supp. 477 (W.D. Mo. 1968), and in *Washington Federal Savings and Loan Association of Miami Beach* v. *United States*, 304 F. Supp. 1072 (S.D. Fla. 1969), we find extensive expositions of the applicable

* Hon. Bruce R. Thompson, United States District Judge, Reno, Nevada, sitting by designation.

statutes and legislative history. Whatever may be said in favor of the proliferation of the printed legal word which has attended the effort of judicial draftsmen to make each opinion an integrated, comprehensive whole, in this situation, where we are concerned with unique and specialized statutory provisions having a tax impact only on one particular segment of the economy, the savings and loan institutions, we discern no advantage in repeating all the arguments, contentions and responses made by the parties here which have been thoroughly considered in the referenced opinions. Neither is it useful to restate the facts in detail, a statement which required twenty-three typewritten pages of the Tax Court opinion. We are writing with the assumption that the reader is familiar with the opinions to which reference has been made.

The taxpayer here is a state-chartered savings and loan association. The *St. Joseph* and *Miami Beach* opinions, *supra*, concerned federal savings and loan associations. The federal institutions are required by law to insure deposits with FSLIC and so to make the premium payments to the Secondary Reserve. A state-chartered institution is not required by law to insure deposits with FSLIC. In this respect, the cases differ. The Tax Court, however, found as a fact that "in the opinion of its (taxpayer's) management loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors", and quite properly refused to distinguish the *St. Joseph* case on account of the difference we have noted. We deem both the *St. Joseph* and *Miami Beach* opinions to be persuasive authority in support of the contentions of this taxpayer and we adopt the cogent arguments in those opinions by reference, without repetition.

The Tax Court opinion approves Revenue Ruling 66-49 (Internal Revenue Bulletin, C.B. 1966-1, January-June 1966, p. 36). The headnote summarizes the ruling.[1] Such

[1] "The additional premium prepayments which an insured savings and loan institution is required to pay to the Federal Savings and Loan Insurance Corporation under the provisions of section 404 of the National Housing Act, as amended, are not deductible when paid and may be deducted only when any possibility of their return

rulings, unlike Treasury Regulations, do not have the force of law and are at most merely persuasive.[2] We think the revenue ruling is wrong.

The question presented is whether the premium payments under 12 U.S.C. § 1727(d), which the taxpayer made into the Secondary Reserve of FSLIC, were deductible as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U.S.C. § 162(a). The Tax Court said no, and characterized the expense as a nondeductible capital expenditure. 26 U.S.C. § 262. In doing so, the Court emphasized the way the Secondary Reserve was accounted for and managed by FSLIC. It pointed out that Section 1727(d) payments "are not considered as income by the FSLIC"; are used "only for losses of the corporation * * * to such extent as other accounts * * * are insufficient"; that the Secondary Reserve account is "rather like a capital account"; that the Secondary Reserve is "part of a pool of capital available to the FSLIC * * * in the event of emergency." We think the emphasis upon the treatment of the receipt by the payee, FSLIC, is mistaken and that in determining whether an expense is an ordinary and necessary expense of doing business, the focus should be on the taxpayer and the taxpayer's business, not on

---

is precluded. With respect to an accrual basis institution, earnings on such premiums are not includible in the gross income of that institution until such time as the earnings are no longer available for losses of the FSLIC. With respect to a cash basis institution, earnings on such premiums are includible in the gross income of the institution credited therewith only when such earnings are used to pay its obligations or become available to that institution without substantial restriction or limitation." Internal Revenue Bulletin, C.B. 1966-1, January-June 1966, p. 36.

[2] *Macey's Jewelry Corp.* v. *United States*, 387 F.2d 70, 72 (5th Cir. 1967); *United States* v. *Bennett*, 186 F. 2d 407, 410 (5th Cir. 1951); cf. *Skidmore* v. *Swift & Co.*, 323 U.S. 134 (1944); *United States* v. *Jefferson Co. Bd. of Educ.*, 372 F. 2d 836, 858 (5th Cir. 1966); *Tandy Leather Co.* v. *United States*, 347 F. 2d 693 (5th Cir. 1965); *Norton Mfg. Corp.* v. *United States*, 288 F. Supp. 829, 835 (N.D. Ill. 1968); *Pauley* v. *United States*, 63 U.S.T.C. para. 9280 (S.D. Cal. 1963); *Kaiser* v. *United States*, 262 F. 2d 367, 370 (7th Cir. 1958), aff'd, 363 U.S. 299 (1960).

what the payee does with the money paid. This is not to say that rights retained by the taxpayer are to be ignored.

Obviously, the payment made to the Secondary Reserve has hybrid characteristics. If this were not so, there would be no lawsuit. The tax impact of the payment must depend upon whether it is more like a capital investment or a business expense.

In opting for the business expense treatment of this expenditure, we first consider whether the revenue ruling to the contrary is inconsistent with the annual accounting concept of income determination and income tax assessment. We think that it is. The importance of this concept was emphasized in *Security Mills Co.* v. *Comm'r*, 321 U.S. 281 (1944), where the Court said:

> "The rationale of the system is this: 'It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.'
>
> "This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount."

To treat the payments of premiums to the Secondary Reserve as the acquisition of a capital asset is a departure from the basic concept of accounting for receipts and disbursements in the year when made (on cash basis accounting). So, it is not just a matter of choosing one treatment or the other. On the contrary, persuasive reasons should appear to justify the departure.

The Commissioner's ruling also ignores another of the most fundamental concepts of federal income taxation. Both federal income taxation and generally accepted

principles of the accounting profession assume that a corporate taxapyer is a "going concern" and will continue indefinitely. Ascertainment of revenue at the end of the accounting period does not hinge upon determination of liquidation value of closing inventories, nor is appreciation or depreciation in value of balance sheet assets considered. This concept is so basic that Congress felt compelled to provide a specific exemption for corporations formed or acquired primarily for liquidation. 26 U.S.C. § 341 (1964). Accordingly, to give consideration to the possibilities of reimbursement because of liquidation or receivership is inconsistent with this principle. The possibility of reimbursement by the taxpayer's voluntary act of termination of coverage is in the same category. The Tax Court found that Appellant's management believed that termination of insurance would cause mass withdrawal by its depositors and, ultimately liquidation. The Court also found that all but an insignificant portion of the savings and loan industry thought it necessary to have insurance coverage. Therefore, the practical realities require the conclusion that termination of coverage is not a proper consideration in determining the finality of the disbursement in issue. Termination here is deemed tantamount to liquidation or receivership.

We also believe that the revenue ruling is inconsistent within itself. It declares (1) that the payments to the Secondary Reserve were not deductible until any possibility of their return was precluded; also (2) that earnings on the Secondary Reserve are taxable to the taxpayer only when they become available to it without substantial restriction or are paid out for its benefit. When we consider that under the "claim for right" doctrine, there must be an impossibility of even constructive possession to defeat taxation of income and that a non-contractual obligation of repayment will not defeat it (*James* v. *United States*, 366 U.S. 213 (1961)) in the context of the "all events" test fixing the accounting period for the allowance of deductions as the one in which all events had occurred which fixed the amount and the fact of the liability (*United States* v. *Anderson*, 269 U.S. 422 (1926); *Dixie Pine Co.* v. *Comm.*, 320 U.S. 516 (1944); *United*

States v. *Consolidated Edison Co.*, 366 U.S. 380 (1961)), there is an incongruity in a ruling that the income credited to the Secondary Reserve allocated to the taxpayer was not then taxable because of the restrictions on its use, while at the same time these same restrictions precluded deduction of the premium payments as business expenses. If there were so many restrictions on the funds paid to FSLIC that the income derived therefrom was not even constructively received and was not taxable when credited, *a fortiori* these same restrictions on reimbursement or recapture of the funds made the payment final and deductible in the year it was made. All events had occurred which fixed the amount and the fact of the liability.

From the point of view of Congressional policy, we should observe that the rule of *United States* v. *Consolidated Edison Co.*, 366 U.S. 380 (1961), holding that a contested tax liability paid under protest could be deducted not in the year of payment but only in the year liability became fixed and final has been reversed by Congress. 26 U.S.C. § 461(f).[3] The Senate Report, in explanation of the 1964 amendment, states, in part: "The objective of the reporting of items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws contain a number of adjustments designed to accomplish this result. Your committee believes that allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up

[3] "(f) Contested liabilities.—If—

"(1) the taxpayer contests an asserted liability,

"(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

"(3) the contest with respect to the asserted liability exists after the time of the transfer, and

"(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

"then the deduction shall be allowed for the taxable year of the transfer." 26 U.S.C. § 461(f).

with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled." U.S. Cong. & Adm. News, 88th Cong., 2nd Sess., p. 1773.

This reaffirmation of basic Congressional policy obviously is not specific authority for our particular problem. It, nevertheless, should incline us to recognizing deductions in the year payment is made rather than to postpone them because of contingent and sometimes quite illusory possibilities of recapture.

The payments made by this taxpayer into the Secondary Reserve of FSLIC meet the tests of necessary business expenses. The expense is "appropriate and helpful" for the "development of the taxpayer's business." *Commissioner* v. *Tellier*, 383 U.S. 687 (1966). To say that they are also "ordinary" is to beg the question which faces us inasmuch as "ordinary" is a qualification designed to exclude expenditures "in the nature of capital expenditures which, if deductible at all, must be amortized over the useful life of the asset." *Commissioner* v. *Tellier*, *supra*. These payments, nevertheless, fulfill our conception of an "ordinary" business expense. It is a recurring annual expense geared primarily to acceleration of the taxpayer's business; that is, the increase in the accounts of the insured members. It is an expense which, from a practical point of view, has to be paid to stay in business. It must be paid regardless of whether income is available for the purpose. The obligation is not associated with an increase of the taxpayer's income. On the contrary, it is generated because of an increase in the taxpayer's liabilities. When these identifying brands are present, it is practical and essential that the character of the expenditure as an ordinary, as well as necessary, business expense be recognized. Otherwise, the impact of the tax may destroy the business.

For the reasons stated, in addition to those articulated in the *St. Joseph* and *Miami Beach* cases, *supra*, we deem Revenue Ruling 66-49 to be unreasonable. The decision of the Tax Court is reversed.

HUFSTEDLER, *Circuit Judge:*

I respectively dissent. There is nothing in the record to support the majority's statement that the payments are a "recurring annual expense." To the contrary, the Tax Court found that in all likelihood the section 1727 (d) payments would be required for a duration of only a few years (until approximately 1971) and that thereafter the suspension provisions of 1727(g) would be in effect. The taxpayer's pro rata share of the Secondary Reserve would then be used to discharge its premium obligations under section 1727(b). "[F]or all practical purposes, [the section 1727(d)] payments will definitely be used to discharge the obligation of the insured institution to pay regular annual premiums in future years, assuming it has not previously transferred its pro rata share of the Secondary Reserve or received a cash payment in respect thereof from the FSLIC." (51 T.C. at 102).

For this and the other reasons expressed by the unanimous Tax Court, I would affirm on the ground that the payments are "in the nature of a prepayment with respect to future premiums," and are not therefore deductible as an ordinary and necessary business expense in the year made.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 23923 (Tax Ct No. 325-68)

[Caption Omitted]

Upon Petition to Review a Decision of The Tax Court of the United States

(Filed and entered Feb. 3, 1970)

JUDGEMENT

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[Caption Omitted]

Excerpt from Proceedings of Wednesday, March 18th, 1970

Order Denying Petition for Rehearing

Before: ELY and HUFSTEDLER, *Circuit Judges*, and THOMPSON, *District Judge*.

On consideration thereof, and by direction of the Court, *It is ordered* that the petition of appellee filed February 20, 1970 and within time allowed therefor by rule of court, for a rehearing of above cause be, and hereby is denied, and rejecting suggestion for rehearing en banc.

SUPREME COURT OF THE UNITED STATES

No. 544, October Term, 1970

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LINCOLN SAVINGS AND LOAN ASSOCIATION

ORDER ALLOWING CERTIORARI. Filed November 9, 1970

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1970 410345 353

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In the Supreme Court of the United States

OCTOBER TERM, 1970

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LINCOLN SAVINGS AND LOAN ASSOCIATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Appendix A, *infra,* pp. 19–62), are reported at 51 T.C. 82. The opinion of the court of appeals (Appendix B, *infra,* pp. 63–72) is reported at 422 F. 2d 90.

JURISDICTION

The judgment of the court of appeals was entered on February 3, 1970 (Appendix C, *infra,* p. 73).

The Commissioner's timely filed petition for rehearing *en banc* was denied on March 18, 1970 (Appendix D, *infra*, p. 75). By order dated June 12, 1970, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including August 15, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a payment by a savings and loan association to the Federal Savings and Loan Insurance Corporation pursuant to Section 404(d) of the National Housing Act is deductible at the time of payment as an ordinary and necessary business expense under Section 162(a) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix E, *infra*, pp. 77–79. The pertinent provisions of the Federal Home Loan Bank Act and the National Housing Act, before and after their amendment in 1961, are set forth in Appendices F and G, *infra*, pp. 81–92.

STATEMENT

Respondent, a state-chartered (California) savings and loan association, is a member of the Federal Home Loan Bank of San Francisco.[1] Respondent insures its

[1] That bank and other federal home loan banks were established under authority of the Federal Home Loan Bank Act, c. 522, 47 Stat. 727 (12 U.S.C. 1421, *et seq.*).

depositors' accounts through the Federal Savings and Loan Insurance Corporation ("FSLIC").[2]

To maintain this insurance in force, respondent is required to pay to FSLIC regular annual insurance premiums. See Section 404(b) of the National Housing Act (Appendix G, *infra*, p. 87).[3] Such premiums are deductible under Section 162(a) of the Internal Revenue Code (Appendix E, *infra*, p. 77). In addition to the "Section 404(b)" payments, respondent has been required since 1962 to make additional annual payments "in the nature of * * * prepayment[s] with respect to future premiums." See Section 404(d) of

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[2] FSLIC, which was created under Title IV of the National Housing Act, c. 847, 48 Stat. 1246 (12 U.S.C. 1724, *et seq.*), operates under the direction of the Federal Home Loan Bank Board. It is required by statute to insure the accounts of all federal savings and loan associations and is permitted to insure the accounts of qualified state-chartered savings and loan associations. Section 403 of the National Housing Act (12 U.S.C. 1726).

[3] Prior to 1962, each institution insured by FSLIC was required to pay a regular annual premium for insurance on depositors' accounts of $\frac{1}{12}$ of one percent of the total amount of its savings accounts and creditor obligations, until such time as FSLIC's reserve for losses equalled or exceeded five percent of the insured accounts and creditor obligations of all insured institutions, and thereafter to make such additional payments as might be required to keep the reserve at this level. Section 404(a) of the National Housing Act (Appendix F, *infra*, pp. 82–83). In 1961, Congress amended Section 404 of Title IV of the National Housing Act (12 U.S.C. 1727), effective January 1, 1962. Act of September 8, 1961, P.L. 87-210, 75 Stat. 482. As amended, Section 404(b) (Appendix G, *infra*, p. 87) continued to require regular annual premiums at the same $\frac{1}{12}$ of one percent rate, but provided that the obligation to pay such premiums should continue only until such time as the general reserve (now called the "Primary Reserve") reached two percent of total insured savings and creditor obligations of insured institutions.

the National Housing Act (Appendix G, *infra*, p. 88).[4] It is the tax character of the "Section 404(d)" payments—whether they are capital expenditures or deductible business expenses—that is here in dispute.

Section 404(b) payments received by FSLIC are part of its gross income, are available to meet its current expenses and losses, and, to the extent not so used, are transferred to FSLIC's "Primary Reserve," to be used, if necessary, to meet future years' losses. Section 404(d) payments, on the other hand, are not considered part of FSLIC's regular income but are transferred directly to FSLIC's "Secondary Reserve," as provided by Section 404(a) of the National Housing Act (Appendix G, *infra*, pp. 86–87). This Reserve is available to FSLIC only to meet its losses and only to the extent that other available accounts are insufficient to meet such losses. Section 404(e) (Appendix G, *infra*, p. 89). The financial statements of FSLIC reveal no year in

[4] Prior to 1962, additional annual payments were not required. Under Section 404(d) of the National Housing Act, as amended by the Act of September 8, 1961 (see n. 3, *supra*), an insured institution must make such payments in an amount equal to two percent of any net increase in its insured accounts during the preceding year, reduced by its obligation, if any, as of the end of such year to purchase capital stock in its federal home loan bank. Pursuant to Section 6(c)(1) of the Federal Home Loan Bank Act (12 U.S.C. 1246) (Appendix G, *infra*, p. 85), which was also amended by the Act of September 8, 1961, a member institution in a federal home loan bank must own capital stock in that bank in an amount at least equal to one percent of the member's outstanding unpaid loan principal. Before 1962, two percent ownership was required. See Section 6 (c) and (l) of the Federal Home Loan Bank Act (Appendix F, *infra*, pp. 81–82). It was contemplated in the Act of September 8, 1961, that the newly imposed Section 404(d) "prepayment requirement would be approximately offset" by the reduction in required outlays for federal home loan bank stock. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2.

which its net insurance losses exceeded even its investment income from the Primary Reserve.

An insured institution has no interest in FSLIC's Primary Reserve. It does have an interest, however, in the Secondary Reserve, which is reflected in the institution's separate account maintained by FSLIC (Section 404(e)), and which is used to pay the institution's regular insurance premiums in future years after the total of the Primary and Secondary Reserves reaches certain levels as hereinafter described. The insured institution's separate account includes a pro rata share of the earnings allocated to the Secondary Reserve "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Section 404(e).

When, at the close of any calendar year, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make Section 404(d) payments is to be suspended until such aggregate amount falls below 1¾ percent of all insured accounts and credit obligations; the obligation is to be terminated when the amount in the Primary Reserve alone equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions.[5] In any year in which the obliga-

[5] Section 404 of the National Housing Act was amended by P.L. 91-151, 83 Stat. 371, enacted on December 23, 1969, to provide that only insured accounts (and not creditor obligations) are to be taken into account in determining the required two percent levels in connection with both the suspension and termination of Section 404(d) payments.

tion to make Section 404(d) payments is suspended, the pro rata share of each insured institution in the Secondary Reserve will be used, to the extent needed and available, to make Section 404(b) payments. Section 404(g) (Appendix G, *infra*, pp. 91-92).

According to FSLIC projections made in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured institutions by 1970, and the Primary Reserve itself would reach the two percent level in 1995.[6]

Although an insured institution's "right, title or interest" in the Secondary Reserve is not generally transferable or assignable, FSLIC has authority to provide for the transfer of an institution's pro rata share "in cases of merger or consolidation, transfer of bulk assets * * * and similar transactions." Section 404(e). Moreover, an insured institution is entitled to a cash refund of its pro rata share in the event that (1) its status as an insured institution is terminated, (2) a conservator, receiver, or other legal custodian is

[6] The FSLIC estimates set out in Appendix A, *infra*, p. 33, show that Section 404(d) payments would be required to be made from 1962 through 1970, and from 1976 through 1979, and that no such payments would be required from 1971 through 1975, and from 1980 through 1995. Because of the 1969 amendment (n. 5, *supra*), the combined Primary and Secondary Reserves reached the two percent suspension level in 1969, rather than in 1970 as originally projected. Beginning this year, the Secondary Reserves are being used to meet the insured institutions' obligations for Section 404(b) payments. FSLIC has not yet prepared a new projection based on the 1969 amendment, but there is no reason to expect that the new estimates will vary significantly from the previous estimates.

appointed for the purpose of liquidating the assets of the institution, (3) FSLIC determines that such institution has gone into voluntary liquidation, or (4) the Primary Reserve alone reaches two percent of the total amount of all insured accounts and creditor obligations of all insured institutions. Section 404(f) and (g) (Appendix G, *infra*, pp. 89–92).

Pursuant to regulations issued by the California Savings and Loan Commissioner and by the Federal Home Loan Bank Board, respondent reported its interest in FSLIC's Secondary Reserve as an asset on its balance sheet and on its published financial statement, and treated the interest earned on its pro rata share of the Secondary Reserve as income.[7] The firm of Peat, Marwick, Mitchell & Co., certified public accountants, stated in their audit of respondent's financial statements for the years 1962 through 1966 that respondent's financial position had been presented fairly therein, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

On its federal income tax return for 1963, respondent deducted both its Section 404(b) and Section 404(d) payments as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code (Appendix E, *infra*, p. 77). The Commissioner allowed the former, but disallowed the

[7] Such interest, which is added to respondent's pro rata share of the Secondary Reserve, is not taxed in the year received but in the year in which it is utilized to pay respondent's regular annual FSLIC insurance premium. Rev. Rul. 66–49, 1966–1 Cum. Bull. 36.

latter. In a unanimous reviewed opinion, the Tax Court agreed with the Commissioner. It held that the Section 404(d) payments were nondeductible capital expenditures, and that such payments could be deducted only when used to pay regular insurance premiums or to meet actual losses of FSLIC. Appendix A, *infra*, pp. 19–62. A divided court of appeals reversed and held the Section 404(d) payments to be currently deductible business expenses. Appendix B, *infra*, pp. 63–72.

REASONS FOR GRANTING THE WRIT

1. The question presented in this case is of substantial fiscal and administrative significance. The decision below affects the tax liabilities of all of the approximately 4,500 savings and loan associations which have insured their depositors' accounts with FSLIC in the 1960's. As of June 10, 1970, 2,487 such associations had on file in the various district directors' offices claims relating to the treatment of Section 404(d) payments totalling more than $72.5 million of tax. Of these cases, 371, involving approximately $19.5 million, are pending administratively within the Ninth Circuit and would be governed directly by the decision below. Although an estimated 2,000 savings and loan associations have not filed claims, they are free to do so to the extent that the statute of limitations has not closed prior years' returns.

Even viewing the question here as one of the proper timing of deductions, the revenues involved are substantial. Statutory interest on the 2,487 claims referred to above will amount to slightly less than

$22 million as of August 15, 1970. This does not take account of additional interest liability which the government may incur if additional claims are filed for prior years. Nor does it reflect the fact that savings and loan associations will be making Section 404(d) payments intermittently until 1979 (see n. 6, *supra*), and that under the court of appeals' decision, the associations will be entitled to deduct these payments currently, rather than at the later time when the payments are applied to discharge their Primary Reserve obligations. The earlier allowance of deductions would result in a substantial loss to the government, because it would be deprived of the use of tax revenue during the interim periods.

Apart from the fiscal implications of the Ninth Circuit's decision, that decision threatens to create serious administrative difficulties. As long as the Commissioner and the Tax Court follow the position they have taken here,[8] and unless and until this Court or every circuit court decides this matter adversely to the government,[9] savings and loan institutions which have deducted Section 404(d) payments currently will be forced to claim deductions for the

[8] Under its recently formulated policy, the Tax Court will accept the Ninth Circuit's decision only in cases in which appellate review lies to the Ninth Circuit. In other cases, it will follow its unanimous reviewed decision in this case. See *Golsen* v. *Commissioner*, 54 T.C. 742, 756–758.

[9] This is a case of first appellate impression. The issue raised was decided adversely to the government in *First Federal S. & L. Ass'n of St. Joseph* v. *United States*, 288 F. Supp. 477 (W.D. Mo.), and in *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, 304 F. Supp. 1072 (S.D. Fla.), now pending on the government's appeal in the Fifth Circuit (No. 29189).

same payments when these payments are later used to discharge regular insurance premium obligations. If they fail to do so, and if the statute of limitations runs on the later years while the earlier years are not closed by the statute of limitations or by *res judicata,* such institutions might be precluded from obtaining any deductions for the disputed Section 404(d) payments, in the event the Commissioner ultimately prevails. Savings and loan associations thus will have no choice but to take inconsistent positions in order to be assured of at least one deduction,[10] and the Commissioner likewise will have to disallow deductions in both taxable years in order to protect the revenues.

Acceptance by the Commissioner of the rule adopted by the Ninth Circuit would not solve the administrative dilemma which this case poses. For example, if there is a significant increase in the tax rate imposed on savings and loan associations, one or more of the 2,000 associations that have thus far followed the rule prescribed by the Commissioner may decide that they would prefer to take their deductions

[10] Sections 1311(b)(2)(B) and 1312(4) of the Code lift the bar of the statute of limitations in certain cases where a deduction disallowed in one taxable year is allowable in another taxable year that otherwise would be closed by the statute. This relief, however, apparently is available only in a case in which the deduction is erroneously claimed by the taxpayer for a taxable year subsequent to the year in which it is properly allowable, not the converse situation presented here. At all events, this matter has not been authoritatively settled, and savings and loan associations could not safely avoid filing protective claims for the later years in reliance on Sections 1311(b)(2)(B) and 1312(4).

in later taxable years when the tax rate is higher, rather than in the earlier years when the rate was lower. Or, a number of these associations may choose for some other reason to continue to report as they have in the past.[11]

This is, then, the rare case in which a definitive resolution of the issue—one way or the other—is almost as important as the outcome. Such a resolution can be provided only through review by this Court at this time.

2. As for the merits, little can be added in support of the government's position to what Judge Raum has said in writing for a unanimous Tax Court. The Tax Court's decision is based on the fundamental tax principle that a cost that results in the creation of an asset with a useful life extending beyond the taxable year may not be deducted in the current taxable year. Treasury Regulations on Income Tax (1954 Code), Section 1.461–1(a), Appendix E, *infra*, pp. 77–79. See *Commissioner* v. *Tellier*, 383 U.S. 687. We think it is clear that respondent's interest in the Secondary Reserve constituted such an asset—a capi-

[11] Precisely this sequence of events occurred in connection with payments made by Texas State banks to the Texas State Depositor's Guaranty Fund in the 1920's. As recounted in detail by the Tax Court (Appendix A, *infra*, pp. 58–60), the Bureau of Internal Revenue first took the position that the payments were deductible when made, but then changed its position. When the new position was rejected by the Board of Tax Appeals, the Bureau reverted to its original position, only to have that position rejected by the Fifth Circuit in a case in which the taxpayer preferred the rule which the Commissioner now urges. See *Wichita State Bank & T. Co.* v. *Commissioner*, 69 F. 2d 595.

tal investment in FSLIC. Perhaps it could be called a forced loan, but it is a loan, and was treated as an asset. Its benefit will inure to respondent, in one form or another, at a future time.

Although respondent had to make Section 404(d) payments in order to maintain its deposits in an insured status, the Section 404(d) payments, unlike the ordinary insurance premiums, are not consumed during the taxable years in which they are made. On the contrary, respondent retains a beneficial interest in the Secondary Reserve and in the investment income earned thereon, which is credited to respondent's account. The payments and income are returnable to respondent at such times (beginning in 1970 and intermittently thereafter) as they are used to discharge respondent's obligation to pay ordinary annual insurance premiums. If not so used, they are returnable in the event of respondent's liquidation, at the time of its withdrawal from the FSLIC system, or when the Primary Reserve alone exceeds the required two percent level. And, respondent's interest in the Secondary Reserve is transferrable to another association in a consolidation, merger, or bulk sale of its assets.

Further evidence that respondent's interest in the Secondary Reserve is a capital investment is provided by the facts that FSLIC is required by law to segregate that reserve from its other assets, and may use it to meet current losses only if its other assets are insufficient for that purpose. These are the classic characteristics of a capital account, for as Judge Raum pointed out (Appendix A, *infra*, p. 52), "what,

after all, is the capital account of any corporation if not a 'Secondary Reserve,' a pool of capital available to creditors in the event that the corporation's current income and retained earnings are not sufficient to satisfy their claims?" [12]

That respondent's liability for the Section 404(d) payment presently in dispute was fixed and determinable as of the end of 1963, and that, except in limited circumstances, respondent's interest in the Secondary Reserve could not be liquidated, cannot alter the conclusion that respondent acquired something of value in the nature of a capital asset. A capital cost is not converted into a deductible expense merely because the liability for the cost is absolute when it is incurred,[13] or because the cost may not easily be recovered through immediate con-

[12] Additional support for the Tax Court's conclusion may be found in the legislative history of the National Housing Act. The Section 404(d) payment requirement was instituted at the same time that Congress lowered the requirement for purchase of federal home loan bank stock by institutions such as respondent, observing that the "prepayment requirement would be approximately offset" by the resulting reduction in outlays for stock. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2; S. Rep. No. 778, 87th Cong., 1st Sess., pp. 1–2. It is thus clear that the intended function of the Section 404(d) payment requirement was to create a temporary pool of capital in the form of a Secondary Reserve, to replace the permanent pool of capital represented by the federal home loan bank stock.

[13] The court of appeals' reliance on *Security Mills Co.* v. *Commissioner*, 321 U.S. 281, is misplaced. That case enunciates the general rule that a business expense deduction is allowable in the year in which it is paid or accrued, depending on the taxpayer's method of accounting. It has no bearing on the question whether a particular cost is an ordinary expense or a capital expenditure.

version into cash or other assets. This is typically true of a loan with a maturity in the future. Nor is it of moment that there was a remote possibility—if FSLIC's other assets were depleted—that the Secondary Reserve would be used immediately to discharge FSLIC's liabilities. In that event, respondent would be entitled to a current deduction. But apart from this, it is axiomatic that the cost of a capital or depreciable asset may not be deducted at the time of acquisition on the ground, for example, that there is an undeterminable possibility of its immediate loss.

The error of the Ninth Circuit's opinion is shown most clearly by its discussion (Appendix B, *infra*, pp. 67–70) of tax accounting concepts. Its conclusion that the Section 404(d) payments are a "recurring annual expense" (Appendix B, *infra*, p. 71) is incorrect as pointed out in Judge Hufstedler's dissenting opinion (*id.*, pp. 71–72). Based on FSLIC's 1961 projections (see n. 6, *supra*), such payments would be required to be made in only 13 of the 34 years between 1962 and 1995.

It is respondent's regular insurance premiums, *not* its Section 404(d) payments, that are its "recurring annual expense." In attempting to match respondent's costs and revenues in accordance with accounting principles, the Ninth Circuit has formulated a rule that has exactly the opposite effect. For, under its decision, there will be some years in which savings and loan associations will receive two deductions, and others in which they will be entitled to no deduction at all, even though they will have the benefit of FSLIC insurance in all taxable years. It is not sur-

prising, therefore, that Peat, Marwick & Mitchell certified respondent's financial statements, in which the Section 404(d) payments were not deducted when paid, as being in accord with generally accepted accounting principles.

3. In holding that respondent's Section 404(d) payment for 1963 was deductible when paid, the Ninth Circuit majority was influenced by its assumption that, since depositors were likely to close their accounts if respondent cancelled its FSLIC insurance, the payment "has to be made to stay in business" (Appendix B, *infra*, p. 71). The fact that a taxpayer's outlay is coerced by force of law or economic circumstances should not alter the nature of the inquiry, which is whether the outlay represents an expense to be offset against income for the year in which it is paid or the creation of a capital asset. *Welch* v. *Helvering*, 290 U.S. 111, 113; *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444, 448 (C.A. 3); *Falstaff Beer, Inc.* v. *Commissioner*, 322 F. 2d 744, 745 (C.A. 5). Indeed, in *Wichita State Bank & T. Co.* v. *Commissioner*, 69 F. 2d 595 (C.A. 5), the Fifth Circuit held that payments by a bank into a depositors' guarantee fund could not be deducted when made, even though such payments were compulsory under Texas law if the bank did not otherwise insure its depositors' accounts. In that case, as in this one, each participating bank's pro rata share was returnable upon its withdrawal from the fund or upon its liquidation. As concluded by the Fifth Circuit (p. 596):

> That fund is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but

> to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. * * * We think the contributions to the $5,000,000 Guaranty Fund, while made annually instead of in a lump sum, were essentially capital investments and ought to be dealt with as such. * * *

That portion of the majority opinion below emphasizing the element of economic compulsion conflicts in principle with the conclusion of the Court of Appeals for the Eighth Circuit in *M.F.A. Central Cooperative* v. *Bookwalter,* 70–1 USTC, par. 9484. It was there held that the taxpayer was not entitled to a business or interest expense deduction for a part of the cost of Class C stock in the Bank for Cooperatives, which was purchased pursuant to Section 42(a)(3) of the Farm Credit Act of 1933.[14] The deduction was disallowed even though the taxpayer was required by law to purchase Class C stock in order to borrow from the cooperative. Squarely in conflict with *M.F.A. Cooperative* is *Penn Yan Agway Cooperative, Inc.* v. *United States,* 417 F. 2d 1372 (Ct. Cl.), where the Court of Claims, like the Ninth Circuit below, relied on the economic compulsion aspect in concluding that a portion of the cost of the Class C stock was deductible as interest.[15] While this case

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[14] C. 98, 48 Stat. 257, 264, as amended by the Farm Credit Act of 1955, c. 785, 69 Stat. 655, 656, Sec. 101, 12 U.S.C. 1134d(a)(3).

[15] The same issue is presented in *Mississippi Chemical Corp.* v. *United States*, 69–1 USTC, par. 9266 (S.D. Miss.), now pending on the government's appeal in the Fifth Circuit (No. 28271).

and the cooperative cases arise in different contexts, the question, insofar as the significance of economic compulsion is concerned, is identical, and is one that warrants present consideration by this Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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AUGUST 1970.

APPENDIX A

51 T.C. No. 10

Tax Court of the United States

LINCOLN SAVINGS AND LOAN ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 325–67—Filed October 21, 1968

Petitioner, a California savings and loan association, insures the accounts of its depositors with the Federal Savings and Loan Insurance Corporation (FSLIC). It pays regular annual premiums for such insurance coverage, which are deductible. Such premiums are part of FSLIC's gross income, available to meet all current expenses and losses, and to the extent not so used are transferred to FSLIC's "Primary Reserve" to meet losses of future years. Since 1962, petitioner has also been required to make additional annual payments "in the nature of * * * prepayment[s] with respect to future premiums." Such "prepayments" immediately become part of the FSLIC's "Secondary Reserve," which is available to a limited extent to meet future losses in the event of depletion of all other resources of the FSLIC. Although petitioner has no interest in the Primary Reserve, it has a pro rata interest in the Secondary Reserve. That interest is reflected in an account which is rendered to it annually by the FSLIC showing the amount of the "prepayments" made by petitioner together with an annual "return" computed upon the

balance in the account at the end of each year. The balance in such account is to be used to discharge petitioner's obligation to pay its regular insurance premiums in future years after the total of FSLIC's Primary Reserve and Secondary Reserve reaches a certain level, but petitioner may transfer its account (its pro rata interest in the Secondary Reserve) to another insured institution in the event of merger, consolidation or bulk sale, and may recover any unused balance in its account in cash if it terminates insurance with the FSLIC or liquidates. Petitioner's pro rata share of the Secondary Reserve appears on its financial statements and the consolidated statements of its parent as an asset, and both State and Federal regulatory agencies require that the "prepayments" be capitalized and not expensed until used to pay premiums or cover losses. *Held,* the "prepayments" are also capital expenditures for Federal income tax purposes, deductible only in the years and to the extent used to discharge petitioner's obligation to pay regular insurance premiums or to meet actual losses of the FSLIC.

Adam Y. Bennion, A. Calder Mackay and *Richard N. Mackay,* for the petitioner.

James A. Thomas, for the respondent.

The Commissioner determined a deficiency in petitioner's income tax of $461,454.38 for the year 1963. Petitioner disputes so much of that deficiency as is based upon the Commissioner's disallowance of a deduction in the amount of $882,636.86, which petitioner claimed as a "Federal Insurance Premium" expense in that year. Petitioner paid this amount to the Federal Savings and Loan Insurance Corporation in 1963, as well as its regular annual insurance premium for that year, as it was required to do by 12 U.S.C. sec.

1727(d), which section characterized the payment as an "additional premium in the nature of a prepayment with respect to future premiums." The issue for decision is whether such payment was an ordinary and necessary expense of petitioner's business in 1963, or whether it was a capital expenditure deductible, if at all, only when actually used to discharge petitioner's obligation to pay regular annual insurance premiums or to meet insurance losses of the Federal Savings and Loan Insurance Corporation.

FINDINGS OF FACT

Some of the facts have been stipulated and, as stipulated, are incorporated herein by this reference together with accompanying exhibits.

Lincoln Savings and Loan Association (hereinafter sometimes referred to as "petitioner") is a corporation organized under the laws of the State of California, incorporated on February 6, 1925. Its name, originally Lincoln Building & Loan Assoication, was changed on August 5, 1943 to Lincoln Savings and Loan Assoication. At the date of the filing of the petition in this case, petitioner's principal office was located at 630 West Sixth Street, Los Angeles, California. It filed its tax returns for the calendar years 1962, 1963 and 1964 on the cash receipts and disbursements basis of accounting with the district director of internal revenue, Los Angeles, California.

All of petitioner's outstanding stock (consisting of 2,500 shares with a par value of $100 per share) has been owned since 1964 by First Lincoln Financial Corporation, which is a corporation organized under the laws of the State of California with its principal office in Los Angeles, California. During 1962 and 1963, First Lincoln Financial Corporation owned

98.88 percent of petitioner's outstanding stock. On December 31, 1963, First Lincoln Financial Corporation had 1,402,654 shares of stock outstanding, without par value, owned by approximately 2,800 shareholders. Its stock is traded over-the-counter.

Petitioner was licensed as a savings and loan association by the Savings and Loan Commissioner of the State of California on February 6, 1925, and since that date has been and remains a licensed savings and loan association under the laws of the State of California, transacting business in the Los Angeles area. As such, it is regulated by Division II of the California Financial Code (West's Annotated California Codes, Financial Code, Section 5000, *et seq.*) and by regulations of the California Savings and Loan Commissioner, which law and regulations are incorporated herein by reference.

Petitioner is a member of the Federal Home Loan Bank of San Francisco, one of twelve regional district banks established and supervised by the Federal Home Loan Bank Board (hereinafter sometimes referred to as the FHLB Board) under authority of the Federal Home Loan Bank Act of 1932. See 12 U.S.C. sec. 1423. These banks provide additional liquidity and funds for mortgage lending by making advances to member institutions as needed to meet unusual or heavy withdrawal and credit demands. As a condition of membership, each member institution is required to purchase capital stock in its bank equal to one percent of its outstanding "unpaid loan principal," and to invest in such amounts of stock thereafter as is necessary to maintain this percentage. 12 U.S.C. sec. 1426(c). Prior to 1962 the statutory level was two percent but thereafter, as part of a comprehensive legislative plan calling for certain additional

payments by "insured institutions" to the Federal Savings and Loan Insurance Corporation, as hereinafter set forth, the level was reduced to one percent.

Since 1938, petitioner has been an "insured institution" of the Federal Savings and Loan Insurance Corporation (hereinafter sometimes referred to as the FSLIC), a corporation created by the laws of the United States under Title IV of the National Housing Act of 1934, 12 U.S.C. sec. 1724 *et seq.*, and operated under the direction of the FHLB Board, which is required by statute to insure the accounts of all Federal savings and loan associations, and is permitted to insure the accounts of qualified state-chartered savings and loan associations, such as petitioner. 12 U.S.C. sec. 1726. Members of the Federal Home Loan Bank system are not required to insure the savings accounts of their depositors with the FSLIC, unless they are also Federally-chartered savings and loan associations. Similarly, except for Federal savings and loan associations, any insured institution of the FSLIC may voluntarily terminate such insurance, provided adequate notice is given to depositors and other technical requirements are met; the FHLB Board may, however, direct an involuntary termination of the insurance of any insured institution under certain conditions, though it has done so only once in the history of the FSLIC. Petitioner placed a great deal of emphasis in its advertising upon the fact that it was a Federally insured institution and, in the opinion of its management, loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors.

Prior to January 1, 1962, each insured institution was required by section 1727(a) of Title 12 of the United States Code (sec. 404(a) of the National

Housing Act) to pay an annual insurance premium to the FSLIC equal to $\frac{1}{12}$ of 1 percent of the total amount of its savings accounts and creditor obligations. Such premiums were to be continued until the FSLIC's reserve for losses equalled or exceeded five percent of the insured accounts and creditor obligations of all insured institutions (its potential liabilities), and at such intervals thereafter as might be required to keep the reserve fund at this level. Public Law 87–210, 75 Stat. 482, pertinent parts of which are set forth in the margin,[1] amended section 1727 of Title 12 of the United States Code, effective January 1, 1962, to its present form. An annual insurance premium at the rate of $\frac{1}{12}$ of one percent is still required of all insured institutions (provision for which is now made in section 1727(b)(1)), though

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[1] Public Law 87–210 amended section 404 of the National Housing Act (12 U.S.C. sec. 1727) to read as follows:

Sec. 1727. Primary and secondary reserves.

(a) Establishment.

The Corporation shall establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) of this section and the credits made pursuant to the first sentence of subsection (e) of this section.

(b) Premiums for insurance; amount; time of payment; waiver, rules and regulations

(1) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 1726 of this title, and thereafter annually, except that under regulations prescribed by the Corporation such premium may be paid semiannually.

(2) If, at the close of any December 31, the Primary Re-

Footnote continued on next page.

the point at which such premiums are to cease and the level at which the FSLIC's general reserve is to be maintained has been lowered from five to two percent of total insured savings and creditor obligations of insured institutions. (Section 1727(b)(2)). But insured institutions are now required under the amended provisions of section 1727, to make further

Footnote 1—Continued

serve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions as of such close, no premium under paragraph (1) of this subsection shall be payable by any insured institution with respect to its premium year beginning during the year commencing on May 1 next succeeding such December 31, except that the foregoing provisions of this sentence shall not be applicable to any insured institution with respect to any of the twenty premium years beginning with the premium year commencing with the date on which such certificate is issued.

(3) The Corporation is authorized to prescribe such rules and regulations as it may determine to be necessary or appropriate to accomplish the purposes and provisions of this subsection.

* * * * *

(d) Prepayments; amount; credit to Secondary Reserve; amount for newly insured institutions.

Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) of this section equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 1426 of this title and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve * * *.

Footnote continued on next page.

annual payments to the FSLIC (provided for in 12 U.S.C. sec. 1727(d) and hereinafter sometimes referred to as "section 1727(d) payments") equal to two percent of any net increase in the total amount of its insured accounts during the previous year, reduced, however, by an amount equal to any requirement, as of the end of such year, for the purchase of stock in a Federal Home Loan Bank of which

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Footnote 1—Continued

(e) Credits to Secondary Reserve; availability for losses; assignment or transfer of share of Reserve.

The Corporation, in accordance with such regulations as it may prescribe, shall credit to the Secondary Reserve, as of the close of each calendar year a return on the outstanding balances of the Secondary Reserve during such calendar year, as determined by the Corporation, at a rate equal to the average annual rate of return to the Corporation during the year ending at the close of November 30 of such calendar year, as determined by the Corporation, on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States. Except as provided in subsections (f) and (g) of this section, the Secondary Reserve shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses. No right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined.

(f) Cessation of prepayments; distribution of share of Secondary Reserve; reinstatement of reserve share; payment; waiver, or other treat of accruals.

If (i) the status of an insured institution as an insured institution is terminated pursuant to any provision of section 1730 of this title or the insurance of accounts of an

Footnote continued on next page.

the insured institution is a member. Public Law 87–210 also amended section 6 of the Federal Home Loan Bank Act (12 U.S.C. sec. 1426), to reduce the percentage of stock which a member of a Federal Home Loan Bank is required to hold in relation to its outstanding home mortgage loans, with certain exceptions relating to stock already purchased, from two to

Footnote 1—Continued

insured institution is otherwise terminated, (ii) a conservator, receiver, or other legal custodian is appointed for an insured institution under the circumstances and for the purpose set forth in subsection (d) of section 1724 of this title, or (iii) the Corporation makes a determination that for the purposes of this subsection an insured institution has gone into liquidation, the obligation of such institution to make prepayments under subsection (d) of this section, including any prepayments as to which such institution is obligated at the time of such termination, appointment, or determination, shall cease, and the Corporation shall pay in cash to such institution its pro rata share of the Secondary Reserve, in accordance with such terms and conditions as the Corporation may prescribe by regulations or otherwise, or, at the option of the Corporation, the Corporation may apply the whole or any part of the amount which would otherwise be paid in cash toward the payment of any indebtedness or obligation, whether matured or not, of such institution to the Corporation, then existing or arising before such payment in cash * * *.

(g) Suspension of prepayments, resumption of obligation upon insufficiency of aggregate reserves; cash distribution of shares of Secondary Reserve.

If, at the close of any December 31, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions but the Primary Reserve does not equal or exceed such 2 per centum, no insured institution shall be obligated to make any prepayment under subsection (d) of this section during the year beginning with May 1 next succeeding such close, and each insured institution's pro rata share of the Secondary Reserve shall be used to the extent available, to discharge such institution's obligation for its premium under subsection (b) of this

Footnote continued on next page.

one percent. It was contemplated that, for most member institutions, the section 1727(d) "prepayment requirement would be approximately offset" by the resulting reduction in outlays for Federal Home Loan Bank stock which a member institution was theretofore (prior to 1962) required to make. H. Rept. No. 823, 87th Cong., 1st Sess., p. 2.

Under the terms of section 1727, as amended by Public Law 87-210, the FSLIC is directed to estab-

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Footnote 1—Continued

section for the premium year beginning in such year; and the suspension of obligation to make such prepayments and the use of such pro rata shares as provided in this sentence shall continue unless and until the next sentence or the last sentence of this subsection shall become operative. If, at the close of any December 31 occurring before the last sentence of this subsection shall become operative, the aggregate of the Primary Reserve and the Secondary Reserve is not at least equal to 1¾ per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions (i) the obligation of insured institutions to make prepayments under subsection (d) of this section shall resume on May 1 next following such December 31 and shall continue unless and until the first sentence or the last sentence of this subsection shall become operative, and (ii) the use of any insured institution's pro rata share of the Secondary Reserve under the first sentence of this subsection shall terminate with respect to its premium under subsection (b) of this section for the premium year beginning during the calendar year commencing on May 1 next succeeding such December 31, and such termination shall continue unless and until the first sentence of this subsection shall become operative. If, at the close of any December 31, the Primary Reserve equals or exceeds such 2 per centum, the Corporation shall, at such time (which shall be the same for all insured institutions and shall not be later than May 1 next succeeding such close) and in such manner as the Corporation shall determine, pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not, after such time, accept or receive further prepayments under subsection (d) of this section.

Footnote continued on next page.

lish a "Primary Reserve," and a "Secondary Reserve". (Section 1727(a)). The Primary Reserve is credited annually with the net income of the FSLIC, and thus represents its "retained earnings." Regular insurance premiums paid by insured institutions under section 1727(b)(1) constitute one of the major items of the FSLIC's gross income, and, to the extent that such premiums exceed expenses and insurance losses in any given year, they are thus transferred as part of FSLIC's net income to the Primary Reserve. Section 1727(d) payments, on the other hand, though described in the statute as "additional premium[s] in the nature of * * * prepayment[s]

Footnote 1—Continued

Public Law 87-210 also amended section 6 of the Federal Home Loan Bank Act (12 U.S.C. sec. 1426) to read as follows:

Sec. 1426. Capital stock.

* * * * *

(c) Minimum subscriptions; retirement of oversubscriptions; limitations; cancellation of oversubscriptions; aggregate unpaid loan principal; reports and information.

(1) The original stock subscription of each institution eligible to become a member under section 1424 of this title shall be an amount equal to 1 per centum of the subscriber's aggregate unpaid loan principal, but not less than $500. The bank shall annually, as of the close of the calendar year, adjust, at such time and in such manner and upon such terms and conditions as the Federal Home Loan Bank Board may by regulations or otherwise prescribe, the amount of stock held by each member so that such member shall have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the next preceding sentence (but not less than $500). If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire the stock of such member in excess of the amount so required. Said Board, in its discretion, may, by regulations or otherwise, provide for adjustments in amounts of stock to be issued or retired in order that stock may be issued or retired only in entire shares.

with respect to future premiums," are not regarded as an item of income by the FSLIC, which is required by section 1727(a) to credit all such payments directly to the "Secondary Reserve." The FSLIC is also required to credit the "Secondary Reserve" with an annual "return" on the outstanding balances in that account at the end of each year, computed "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Section 1727(e). Finally, whereas the "Primary Reserve" is "the general reserve of the Corporation [i.e., the FSLIC]," the "Secondary Reserve" is available "only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses." Section 1727(e).

Each insured institution maintains an interest in a pro rata share of the "Secondary Reserve," and though its "right, title or interest" therein is not generally transferable or assignable, the FSLIC has authority to provide for the transfer of such pro rata share "in cases of merger or consolidation transfer of bulk assets * * * and similar transactions." Section 1727(e). Moreover, an insured institution is entitled to a cash refund of its pro rata share in the event that (1) its status as an insured institution is terminated, or (2) a conservator, receiver, or other legal custodian is appointed for the purpose of liquidating the assets of the institution, or (3) the FSLIC determines that such institution has gone into voluntary liquidation. Section 1727(f).

When, at the close of any December 31, the *aggregate* of the Primary Reserve and the Secondary Re-

serve equals or exceeds two percent of the total amount of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make section 1727(d) payments will be suspended for the following year and all succeeding years; the obligation to make section 1727(d) payments is to resume in the year following any December 31 on which such aggregate amount falls below 1¾ percent of all insured accounts and creditor obligations, and is to terminate permanently when the amount in the Primary Reserve alone equals or exceeds two percent of such accounts and obligations. In any year in which the obligation to make section 1727(d) payments is suspended, as described above, the pro rata share of each insured institution in the Secondary Reserve will be used, to the extent available, to discharge its obligation to pay the regular insurance premium for that year. After the Primary Reserve alone reaches the two percent level, each insured institution is entitled to the return of its pro rata share of the Secondary Reserve, if any, in cash. Section 1727(g).

A schedule appearing shortly hereinafter sets forth estimates of the reserve position of the FSLIC in terms of the expected ratio of the Primary Reserve, the Secondary Reserve, and the aggregate of the Primary and Secondary Reserves to the total of all accounts and creditor obligations of all insured institutions for the years 1962–1995. These estimates, prepared in the Office of the Comptroller of the FSLIC and submitted to the Senate Committee on Banking and Currency in connection with that Committee's consideration of the bill which became Public Law 87–210, were based upon certain assumptions, *viz:*

400-943—70——3

1. No insurance losses.[2]

2. Premium income computed on annual billing basis of one-twelth of 1 percent.

3. Investment income based on annual average rate of return of 3 percent.

4. Operating expenses based on current rate of expenditure equal to 3.7 percent of premium income.

5. Mortgage loans held estimated at 96 percent of total savings capital.

6. Net home mortgages estimated at 90 percent of mortgage loans held.

7. Annual growth in savings of $7 billion plus dividends at an annual rate of 3 percent.

In addition to the foregoing estimates, the schedule also shows the *actual* percentage of the aggregate of the Primary and Secondary Reserves to the total amount of all accounts and creditor obligations of insured institutions during the years 1963–1967, as shown on the financial statements of the FSLIC for those years. The schedule described above is as follows:

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[2] The FSLIC, during the 27 years of its existence prior to June 30, 1961, had incurred net insurance losses of only $5.1 million, approximately 1.1 percent of its cumulative gross income.

December 31	Primary reserve—estimated ratio	Secondary reserve—estimated ratio	Aggregate of primary and secondary reserves	
			Estimated ratio	Actual ratio
1962	0.642	0.227	0.869	.....
1963	0.661	0.417	1.078	*1.04
1964	0.685	0.581	1.266	1.20
1965	0.712	0.723	1.435	1.35
1966	0.741	0.849	1.590	1.53
1967	0.773	0.963	1.736	1.62
1968	0.807	1.067	1.874	.....
1969	0.842	1.148	1.990	.....
1970	0.879	1.177	2.056	.....
1971	0.917	1.032	1.969	.....
1972	0.956	0.935	1.891	.....
1973	0.996	0.825	1.821	.....
1974	1.036	0.720	1.757	.....
1975	1.078	0.620	1.699	.....
1976	1.121	0.667	1.787	.....
1977	1.164	0.710	1.874	.....
1978	1.208	0.752	1.960	.....
1979	1.252	0.792	2.045	.....
1980	1.208	0.696	1.904	.....
1981	1.343	0.603	1.946	.....
1982	1.390	0.512	1.902	.....
1983	1.437	0.424	1.860	.....
1984	1.484	0.338	1.822	.....
1985	1.532	0.253	1.785	.....
1986	1.580	1.171	1.751	.....
1987	1.629	0.218	1.848	.....
1988	1.679	0.264	1.943	.....
1989	1.729	0.309	2.038	.....
1990	1.779	0.226	2.005	.....
1991	1.830	0.145	1.975	.....
1992	1.881	0.074	1.955	.....
1993	1.932	.....	1.932	.....
1994	1.984	.....	1.984	.....
1995	2.037	.....	2.037	.....

*As of June 30, 1963.

In summary, according to the FSLIC projections in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured institutions by 1970, and all section 1727(d) payments, together with all amounts credited thereon, would be consumed in discharging the obligation of insured institutions to pay regular insurance premiums by the time that the Primary Reserve itself reaches the two percent level in 1995.

During the years 1962 through 1967, petitioner received annual "Insurance Premium Notices" from the FSLIC charging it with "Annual Premium[s] at rate of $\frac{1}{12}$ of 1%" (of its insured accounts and creditor obligations) in the following amounts:

Year:	*Premiums*
1962	$93,258.58
1963	135,760.52
1964	196,413.86
1965	271,477.00
1966	317,427.60
1967	373,025.38

All such sums were paid by petitioner to the FSLIC in the year assessed.

During each of those same years, petitioner also received from the FSLIC a separate "Notice of Insurance Premium Prepayment," which set forth the amounts due from petitioner, and the manner in which computed, generally as follows:

Year	Increase in accounts of petitioner's insured members (depositors) during preceding year	Gross prepayment (2% of increase in prior year)	FHL bank stock credit	Net amount due June 1
1962	$6,337,974	$126,759.48	0	$126,759.48
1963	44,131,843	882,636.86	0	882,636.86
1964	61,746,484	1,234,929.68	$784,100.00	450,829.68
1965	71,489,450	1,429,789.00	334,700.00	1,095,089.00
1966	61,303,238	1,226,064.76	0	1,226,064.76
1967	(1,944,138)	0	0	0

All such section 1727(d) payments billed to petitioner were paid by it to the FSLIC in the year due.

All section 1727(d) payments have been credited on the books and records of the FSLIC directly to its "Secondary Reserve." Effective with the first of such payments, the FSLIC has maintained separate accounts for each insured institution and annually forwards statements to such institutions showing, among other things, the total amount of section 1727(d) payments made to that time, the interest credited annually by the FSLIC to the account pursuant to section 1727(e), and the insured institution's pro rata share of the Secondary Reserve. Petitioner's account, No. 2066, reflects the following:

Date	Sec. 1727(d) payment	Annual return		Pro rata share of secondary reserve		
		Rate	Amount	Debit	Credit	Balance
May 31, 1962	$126,759.48				$126,759.48	$126,759.48
Dec. 31, 1962		3.151433%	$2,342.10		2,342.10	129,101.58
May 31, 1963	882,636.86				882,636.86	1,011,738.44
Dec. 31, 1963		3.549594%	22,951.42		22,951.42	1,034,689.86
May 28, 1964	450,829.68				450,829.68	1,485,519.54
Dec. 31, 1964		(1)	44,864.25		44,864.25	1,530,383.79
June 1, 1965	1,095,089.00				1,095,089.00	2,625,472.79
Dec. 31, 1965		3.555086%	77,231.97		77,231.97	2,702,704.76
June 1, 1966	1,226,064.76				1,226,064.76	3,928,769.52
Dec. 31, 1966		3.337323%	131,295.86		131,295.86	4,060,065.38
June 1, 1967	0				0	4,060,065.38
Dec. 31, 1967		4.232271%	171,832.97		171,832.97	4,231,898.35
Dec. 31, 1967					[2]690,217.11	4,922,115.46

[1] Not in record.
[2] Transferred from the account of another savings and loan association due to merger.

Section 8701 of the California Financial Code authorizes the Savings and Loan Commissioner to establish a uniform classification of accounts for savings and loan associations and to prescribe the manner in which such accounts are to be kept. On May 21, 1962, the California Savings and Loan Commissioner issued an order prescribing the procedure for accounting for section 1727(d) payments, which order was modified and incorporated into the "Uniform Classification of Accounts" effective January 1, 1963, and,

as modified, has remained effective for all subsequent periods. The "Uniform Classification of Accounts" requires each California savings and loan association to treat section 1727(d) payments as an asset, in an account entitled "Contributions to Secondary Reserve—FSLIC;" to treat the return credited to its pro rata share of the Secondary Reserve as income when notified by the FSLIC that such return has been credited to its account; and to treat transfers made from its pro rata share of the Secondary Reserve to discharge its obligation to pay regular annual premiums as expenses when notified of such transfer.

On petitioner's balance sheet for the year 1962, its section 1727(d) payment for that year, and the statutory interest credited thereon, were included in "Other Assets;" beginning in 1963, all section 1727(d) payments have been shown, on the asset side of the balance sheet, as "Prepaid Federal Savings and Loan Insurance Corporation Premiums." Such payments were not included as an expense on any of its income statements for the periods 1962 through 1966. The interest credited to petitioner's account pursuant to section 1727(e) by the FSLIC for each of the years 1962 through 1966 was included in miscellaneous income for the year in which the interest was credited to petitioner's account by the FSLIC. These items were similarly treated on the Consolidated Financial Statements of petitioner's parent, First Lincoln Financial Corporation, and its subsidiaries. All of petitioner's financial statements for the years 1962 through 1966, and all consolidated financial statements of its parent for those years, were audited by the firm of Peat, Marwick, Mitchell & Co., certified public accountants, which submitted accompanying "Accountant's Reports" stating that the financial position of petitioner

(or its parent) had been presented fairly therein, "in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

The regulations of the FHLB Board require each savings and loan association which is a member of the Federal Home Loan Bank system to file, on forms provided by the Board, a semi-annual report of its affairs as of the end of each semiannual period. Printed instructions for the preparation of such reports are published and distributed to each member. The "Introduction" to these instructions states that: "These instructions are provided to assist in the completion of monthly and semiannual reports by members of the Federal Home Loan Bank System. Each reporting institution is urged to carefully follow these instructions * * *." Under the heading "Schedule D, Other Assets," each institution insured by the FSLIC is instructed to report in that category "the amount of its pro rata share in the Secondary Reserve established by the Corporation from the premium prepayments." In all of its reports to the FHLB since 1962 petitioner has reported its pro rata share of the Secondary Reserve as an asset under the heading "Other Assets," as required by such instructions.

On its Federal income tax returns for the years 1962, 1963 and 1964, petitioner deducted both its section 1727(b)(1) regular premium payments and its section 1727(d) payments under "other deductions" as "Federal insurance premiums." Upon examination of its returns for those years, the Commissioner allowed the deduction for amounts paid under section 1727(b)(1), but disallowed a deduction for all section 1727(d) payments. In its petition to this Court, petitioner put in issue the greater part of the deficiency

in its income tax as determined by the Commissioner with respect to the calendar year 1963.[3] It concedes the correctness of all the adjustments made by the Commissioner for 1963 with the exception of his disallowance of a deduction of $882,636.86, the amount of the section 1727(d) payment made by petitioner in that year.

OPINION

RAUM, *Judge*: Petitioner, a savings and loan association licensed by the State of California and doing business in the Los Angeles area, has since 1938 insured the savings accounts of its depositors with the Federal Savings and Loan Insurance Corporation (the "FSLIC"), pursuant to the provisions of Title IV of the National Housing Act, as amended. (12 U.S.C. sec. 1724 *et seq.*) It pays an annual "premium for such insurance" in an amount equal to 1/12 of one percent of the total amount of all its savings accounts and creditor obligations, as provided in section 1727(b)(1). Since 1962, as the result of amendments made to the National Housing Act, petitioner has been required to make further annual payments to the FSLIC under section 1727(d), hereinafter sometimes referred to as "Sec. 1727(d) payments", equal to two percent of any net increase in its insured accounts during the previous year, but reduced in the case of an insured institution, such as petitioner, which is also a member of a Federal Home Loan Bank, by the amount of any required purchase of stock in such Bank for that year. These section 1727(d) payments are described in the statute as "additional premium[s]in the nature of * * * prepayment[s] with respect to future premiums." In 1963, the only year

[3] There was no deficiency in petitioner's income tax in the other years.

here in issue, petitioner paid its annual insurance premium for the year in the amount of $135,760.52, and made its section 1727(d) payment in the amount of $882,636.86. Both sums were deducted on its 1963 Federal income tax return as "Federal insurance premiums." The Commissioner, while not disputing petitioner's right to deduct its regular annual insurance premium, disallowed in full the deduction of $882,636.86 claimed for the additional section 1727(d) payment. The sole issue for decision is whether this latter payment was an ordinary and necessary expense of petitioner's business in 1963, or a capital expenditure deductible, if at all, only in later years to the extent that it ceased to be an asset of petitioner.

Although described in the statute as "an additional premium in the nature of a prepayment with respect to future premiums," the section 1727(d) payment is neither an "additional premium," in the sense of being a mere increase in the annual insurance premium as contended by petitioner, nor a "prepayment with respect to future premiums," at least insofar as the ordinary prepaid insurance premium is taken as a standard. The National Housing Act is not, of course, a revenue statute, and the label attached to section 1727(d) payments therein is not, and was not intended to be, conclusive in the determination of how these payments should be treated for Federal tax purposes. See *McMillan Mortgage Company*, 36 T.C. 924, 928. The label is at any rate ambiguous, though if we were to give it binding effect here, we should most certainly adopt the characterization of "prepayment" as controlling, and would therefore have to deny petitioner a current deduction for its section 1727(d) payment under a long line of decisions by this Court holding that prepaid insurance premiums

are capital expenditures to be expensed over the years in which coverage is actually obtained. *Higginbotham-Bailey-Logan Co.*, 8 B.T.A. 566, 577; *George S. Jephson*, 37 B.T.A. 1117, 1119–1120; *Martha R. Peters*, 4 T.C. 1236, 1242; *Louise K. Herter*, 20 T.C.M. 78, 86. See and compare *Commissioner* v. *Boylston Market Ass'n.*, 131 F. 2d 966 (C.A. 1), affirming a Memorandum Opinion of the Board of Tax Appeals, with *Waldheim Realty and Investment Company* v. *Commissioner*, 245 F. 2d 823 (C.A. 8), reversing 25 T.C. 1216. But regardless of whether the section 1727 (d) payment may properly be characterized as a prepaid insurance premium, we reach the same ultimate result, for an analysis of the substantive provisions of section 1727 convinces us that this payment, however labeled, is in the nature of a capital outlay and is therefore not deductible as an expense in the year that it is made.

That the section 1727(d) payment is qualitatively different from the regular annual insurance premium payable under section 1727(b)(1), and constitutes something more than a mere increase in the premium rate, seems to us beyond question. Regular annual premiums are part of the gross income of the FSLIC and, along with its income from investments, are used to meet the FSLIC's operating expenses and insurance losses, if any, for the year. To the extent that such premiums are not so used, they are transferred, as part of the FSLIC's net income for the year, to the "Primary Reserve," the FSLIC's general reserve which contains its cumulative net income or "retained earnings" and which is available to meet the FSLIC's insurance losses if its income in any year is insufficient for this purpose. Section 1727(d) payments, on the other hand, are not considered as income by the FSLIC, and are not ordinarily available to meet the

annual expenses and losses of the Corporation. Instead, the FSLIC is required by statute to credit all such payments directly to a "Secondary Reserve," which is to be used "only for losses of the Corporation and shall be so available *only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses.*" Section 1727 (e). (Emphasis added.) Thus, instead of being taken into income, freely available to meet expenses and losses of the current year, the section 1727(d) payment is credited directly to an account, rather like a capital account, which may be applied against losses only in the event that the regular insurance premiums for the year, the corporation's other income, and its retained earnings of prior years have all been depleted. It cannot, therefore, be accurately termed a premium for insurance coverage in the year of payment, but, at least initially, is in reality a capital investment in the FSLIC, part of a pool or capital available to the FSLIC for the payment of losses in the event of emergency.

Furthermore, when the regular insurance premiums paid by insured institutions under section 1727 (b)(1) are received by the FSLIC, they lose their distinctive character as premiums and become merely part of the gross income of the corporation; the insured institution retains no rights in respect of such sums, other than the right to insurance coverage for the current year, and its premium, once paid, is lost to it forever. Payments made under section 1727(d), however, stand on quite a different footing. Such payments, as noted above, are immediately segregated in the "Secondary Reserve," and the FSLIC is directed by statute to credit the outstanding balance in this account, on an annual basis, with a "return"

computed "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Section 1727(e). What is more, each insured institution maintains an interest in a pro rata share of the Secondary Reserve, and is annually furnished with a statement of its account by the FSLIC, which keeps a separate account for each insured institution. That annual statement discloses all section 1727(d) payments made by the insured institution, the interest or return earned by the account, any debits that may have been charged aganist the account, and, finally, the new balance in the account as of the end of the year. Thus, for the years 1962–1967, petitioner's account, set forth in our findings, reflects various credits (section 1727(d) payments and interest or return), no debits, and a balance of $4,922,115.46 in its favor, representing its pro rata share in the Secondary Reserve as of December 31, 1967.

While petitioner's pro rata share of the Secondary Reserve is not, as a general rule, assignable or transferable, "by operation of law or otherwise," the value of such share may be fully realized through its transfer to another insured institution in a merger, consolidation or bulk sale; petitioner may even receive the value of its share from the FSLIC in cash if (1) its insured status is terminated, either voluntarily or involuntarily, (2) it goes into liquidation, voluntarily are involuntarily, or (3) the obligation to make section 1727(d) payments is permanently terminated and the Secondary Reserve distributed before the value of its share has otherwise been fully recovered. See p. —, *infra*. Moreover, assuming petitioner does not realize the value of its pro rata share in one of the above ways, it is reasonably assured of receiving

full value therefor in the form of insurance coverage in future years when its share of the Secondary Reserve is used to pay its regular section 1727(b)(1) premiums. To the extent that the petitioner's share is so used, entries will undoubtedly be made in the debit column of its account which will be reflected in the balance appearing as of the end of each such year. Also, to the extent that any losses may be charged in any year against the Secondary Reserve, petitioner's pro rata share thereof should similarly appear in the debit column, thereby also adversely affecting its balance as of the end of such year. And to the extent that any such debits are charged against petitioner's balance in any particular year, whether for regular section 1727(b)(1) premiums or for losses, it would seem that petitioner would be entitled to deductions in those amounts for any such year. Cf. Rev. Rul. 66–49, 1966–1 C.B. 36, 37.

As already noted, the Secondary Reserve is available for the payment of losses, but only to a very limited extent. It has, however, never been used for this purpose, nor, on the basis of the FSLIC's past loss experience, does such use appear to be likely. At the time that Congress considered Public Law 87–210, in 1961, net insurance losses of the FSLIC had absorbed only 1.1 percent of its gross income over its entire existence, H. Rept.No. 823, 87th Cong. 1st Sess. p. 2 (1961); S. Rept. No. 778, 87th Cong. 1st Sess. p. 2, and the financial statements of the FSLIC put in evidence by the parties, covering all the years thereafter through December 31, 1967, reveal no year in which the net insurance losses of the FSLIC exceeded even its investment income, much less the annual premiums for the year and/or the Primary Reserve, both of which must be fully consumed before

the Secondary Reserve can be utilized. The Primary Reserve alone stood at $921,669,395 on Deember 31, 1967, while the *cumulative* net losses of the FSLIC from June 27, 1934 through December 31, 1967, totalled only $105,610,365. Of course, an event of catastrophic proportions, another Great Depression, could conceivably wipe out the Secondary Reserve, but the probability that such an event will occur is simply incalculable. It is certainly not an event that could reasonably be anticipated as of any particular time, and if any event should occur requiring a charge against the Secondary Reserve in respect of any loss, petitioner's pro rata share thereof would then be deductible, as has already been pointed out. But there do not appear to be any greater hazards in this respect than attach to the capital investment made by a stockholder in a commercial bank or an insurance company.

Though it is clear that "prepayments" under section 1727(d) are not really insurance premiums, at least not in the year in which they are paid, a further examination of the provisions of Public Law 87-210 also reveals sharp differences between such "prepayments" and the ordinary prepaid insurance premium. While the average prepaid insurance premium gives rise to an obligation on the part of the insurer to provide coverage for some definitely ascertainable period of time, usually not more than two or three years from the date of the policy, the FSLIC incurs no such obligation upon its receipt of a section 1727(d) payment. The obligation to provide insurance coverage does not arise until the section 1727(d) payment is actually used to discharge the obligation of the insured institution to pay a regular section 1727(b)(1) insurance premium, which event is contingent upon the ratio of the FSLIC's reserves to its potential liabilities attaining certain levels. Moreover, since the section

1727(d) payment credited to the Secondary Reserve is subject to accretion through the annual "return" credited annually by the FSLIC on the outstanding balance in such reserve, and at least theoretically to depletion in the event the reserve is used to meet losses in an emergency situation, and since the regular annual premium required by section 1727(b)(1) is itself a percentage of the insured institution's accounts and creditor obligations, and thus varies from year to year, there is no way of predicting with certainty the number of years of insurance coverage which will be procured by each section 1727(d) payment, much less the precise years which will be covered. Thus, unlike the common prepaid insurance premium, the section 1727(d) payment is not simply "an exhaustible asset with a determinable life" whose value may be allocated "ratably over the term for which the premium is paid," see *George S. Jephson, supra,* 37 B.T.A. 1117, 1120; *Higginbotham-Bailey-Logan Co., supra,* 8 B.T.A. 566, 577, the life of the asset created by the section 1727(d) payment is not determinable on the date of payment, and its usefulness will not be ratably spread over the period of that life.

For the period of time prior to its use to discharge the obligation of the payor institution to pay regular annual premiums required by section 1727(b)(1), the section 1727(d) payment will simply constitute part of the capital of the FSLIC. Under the terms of the statute, section 1727(g), the pro rata share of each insured institution in the Secondary Reserve will be used to pay its regular annual premiums, and the obligation of insured institutions to make section 1727(d) payments will concurrently be suspended, only after the aggregate of the FSLIC's Primary and Secondary Reserves equals or exceeds two percent of

the total amount of all savings accounts and creditor obligations of institutions insured by the FSLIC. The obligation to make section 1727(d) payments will, however, resume, if the aggregate of the two reserves subsequently falls below 1¾ percent of the FSLIC's potential liabilities, and, until such aggregate again reaches the two percent level, the use of the pro rata share of each insured institution to pay its regular annual premiums must also cease. It is not until the FSLIC's Primary Reserve alone equals or exceeds two percent of its potential liabilities that the obligation to make section 1727(d) payments will permanently terminate, at which time insured institutions are entitled to the refund of their pro rata share of any amount remaining in the Secondary Reserve. Clearly then, the effect of these provisions is to require insured institutions to make and keep capital investments in the FSLIC, until it has retained enough of its own earnings (in the Primary Reserve) to provide, in the opinion of Congress, adequate protection for insured savers.

To be sure, the asset acquired by petitioner by virtue of its section 1727(d) payments, i.e., its pro rata share of the FSLIC's Secondary Reserve, differs in many respects from the usual capital investment. Petitioner is required by law to make the investment, at least as long as it wishes to insure its accounts with the FSLIC, cf. *Hotel Sulgrave, Inc.*, 21 T.C. 619, the amount of the investment is determined by the growth of its business, i.e., the increase in its savings accounts, and the asset so acquired is ordinarily not transferable to others. But these differences, though perhaps not insignificant for other than tax purposes, cannot alter the fact that the section 1727(d) payment does not actually provide insurance coverage for petitioner in the year of payment, and is not an ordi-

nary and necessary expense of that year; it results in the acquisition of an asset which, if held to "maturity" and not transferred in a merger, consolidation or bulk sale, and not refunded in the event of a termination of insurance or liquidation, will result in benefits, in the form of insurance coverage, in future years. In these circumstances, it is a matter of no consequence whether petitioner is a cash or accrual basis taxpayer, for the rule is the same for both that: "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made." Regs. sec. 1.461–1(a)(1) and (2). Moreover, we need not look far to find a similar investment which, though possessing many of these same peculiar attributes, is nevertheless a capital expenditure. An example readily at hand lies in the payment by petitioner of amounts required by section 6 of the Federal Home Loan Bank Act, 12 U.S.C., section 1426(c), for the acquisition of capital stock in its Federal Home Loan Bank, a payment which we think is closely analogous to the section 1727(d) payment here, and which petitioner has consistently capitalized rather than expensed in the year of payment.

Membership in a Federal Home Loan Bank entitles a savings and loan association to obtain advances from such Bank, up to certain limits, upon the security of its home mortgages and obligations of or guaranteed by the United States, 12 U.S.C. section 1430(a); it thus serves the important function of providing members with a source of additional liquidity and funds for mortgage lending. As a condition of membership, the savings and loan association must initially purchase stock in one of twelve regional Home Loan

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Banks, depending upon the district in which it is located, equal to one percent of such association's "aggregate upaid loan principal," [4] and must purchase such additional amounts of stock thereafter as is necessary to maintain this ratio at the close of each succeeding calendar year. 12 U.S.C. sec. 1426(c)(1). Amounts so invested are not ordinarily transferable, and, in general, are returnable to the member only upon its withdrawal from membership. Also, if at the time of withdrawal the FHLB Board finds that the paid-in capital of the member's Federal Home Loan Bank is or is likely to be impaired as a result of losses in or depreciation of the assets held by such Federal Home Loan Bank, the amount to be paid the member in retirement of its stock is reduced by its pro rata share of the amount of the impairment. 12 U.S.C. sec. 1426(i). The similarities between the mandatory payments made by petitioner to its Federal Home Loan Bank and those made to the FSLIC are thus strikingly apparent.[5] True, petitioner did not re-

[4] Defined as the aggregate unpaid principal of its home mortgage loans, home-purchase contracts, and similar obligations. 12 U.S.C. sec. 1426(c)(4).

[5] Petitioner argues that the legally compelled investments made in its Federal Home Loan Bank are fundamentally distinguishable from the section 1727(d) payments here by virtue of the fact that it is entitled to dividends on its Federal Home Loan Bank stock which are immediately available for its use, and the further fact that the Federal Home Loan Bank may, "in its discretion," retire the stock of any member to the extent that it exceeds the required ratio. Although these are distinctions, they are nevertheless distinctions without a difference here. We do not consider it significant that petitioner's annual dividends on its Federal Home Loan Bank stock are distributed to it rather than being credited to its account, nor do we think it important that petitioner may receive some of the funds invested in the Federal Home Loan Bank

ceive any pieces of paper to evidence its pro rata share of the Secondary Reserve, though one could imagine a redeemable preferred stock which incorporated all the provisions of sections 1727(d), (e), (f) and (g) as described above, which might have been issued in exchange for such payments. But it acquired an asset nevertheless, if evidenced only by the annual statements sent to petitioner every year showing the status of such pro rata share. That the section 1727(d) payment made to acquire that asset was mandatory and based upon the volume of petitioner's business, and that the asset itself was nontransferable and subject to a limited extent to the losses of the corporation in which the funds were invested, does not make it any more an ordinary and necessary expense, nor less a capital expenditure, than the required investments made by petitioner in its Federal Home Loan Bank.

Moreover, the section 1727(d) payments, which are measured by the net increase of the institution's insured accounts during the preceding year, were in fact regarded by Congress, in part at least, as being a substitute for investments in the capital stock of the Federal Home Loan Banks which member in-

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before it begins to receive, actually or constructively, its section 1727(d) payments. Moreover, assuming that it remains a member of both the Federal Home Loan Bank and the FSLIC indefinitely, petitioner will certainly receive its total investment in the FSLIC before it receives the money it has invested in its Federal Home Loan Bank, for while there is a definite limit on petitioner's commitment to the FSLIC, there is none on its commitment of funds to the Federal Home Loan Bank. At any rate, the question of when such investments or the return thereon, will be redeemed is simply a question of timing; the important point is that both are in fact capital investments.

stitutions were theretofore required to make. A member institution was formerly obligated to purchase and hold such capital stock equal to two percent of its outstanding home mortgage loans, but when its obligation to make the section 1727(d) payments commenced in 1962, the two percent level in respect of the capital stock was simultaneously reduced to one percent. It is clear that Congress regarded these as interrelated events,[6] and in our judgment the 1727(d) payments represented capital outlays by the member institution just as much as its investment in the stock of its regional Federal Home Loan Bank.

The legislative history of Public Law 87–210, which amended section 1727 to its present form in 1961, does not of course deal with the manner in which section 1727(d) payments should be treated for Federal tax purposes, but it is certainly not inconsistent with anything we have said here. The decade preceding the enactment of the bill witnessed a tremendous increase in the growth of institutions insured by the FSLIC, and a concomitant growth in the total amount of savings insured by the Corporation. But, in that same decade, the FSLIC was required by Congress to use its income to retire all of its capital stock, in the amount of $100,000,000, from the United States Treasury. The result was a decline in the ratio of the reserves of the FSLIC to its potential liabilities during this period from 0.843 percent to 0.661 percent. See S. Rept. No. 778, 87th Cong., 1st Sess., pp. 2, 12; Hearings Before Subcommittee No. 1 of the Committee on Banking and Currency, House of Representatives, 87th Cong., 1st Sess., on H.R. 7108 and H.R. 7109, pp. 10, 39. Public Law 87–210 was "designed to add new strength" to the FSLIC by requiring in-

[6] See *infra*, p. —.

sured institutions to make so-called "premium prepayments" which, it was hoped, "would result in a marked acceleration in building up the Corporation's reserves." H. Rept. No. 823, 87th Cong., 1st Sess., p. 2 (1961); S. Rept. No. 778, *supra,* pp. 1–2.

Petitioner emphasizes that Congress spoke in terms of building up the FSLIC's *reserves,* that section 1727(d) payments are in fact credited to a "Secondary Reserve," and concludes that a necessary corollary is that payments made to a reserve must be insurance premiums. This is no more than semantic word play. The truth of the matter is that, for the reasons outlined at the beginning of this opinion, section 1727(d) payments cannot be considered merely additional insurance premiums. Had Congress felt that the premium income of the FSLIC was inadequate to meet expenses and losses, it could easily have increased the regular annual premium to what it considered a more realistic level, without enacting all the complicated provisions which govern section 1727(d) payments. But, in fact, during the entire life of the corporation its total expenses had, to 1961, amounted to only 3.7 percent of its gross income while net insurance losses had absorbed "a mere 1.1 percent of the gross income." Hearings, *supra,* p. 10. Cf. H. Rept. No. 823, *supra,* p. 2, S. Rept. No. 778, *supra,* p. 2. What was needed was additional capital, not additional premium income, which would serve as a buffer until the FSLIC had accumulated enough of its own income to bring its "Primary Reserve," the true insurance reserve, to the desired two percent level.[7]

[7] Compare the statement of Everett C. Sherbourne, vice-chairman, Federal Legislation Committee, National League of Insured Savings Associations, Hearings, *supra* p. 45. "From the standpoint of the loss experience of the Corporation, we do not believe the reserve would be inadequate * * *. There is, how-

True, Congress called the account to which this additional caiptal was credited a "Secondary Reserve," but since such "reserve" served the same function as a capital account, and was available for losses "only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses," Congress' use of the terminology of the insurance industry should not confuse the issue. And what, after all, is the capital account of any corporation if not a "Secondary Reserve," a pool of capital available to creditors in the event that the corporation's current income and retained earnings are not sufficient to satisfy their claims?

As has previously been pointed out, at the same time and in the same measure directing insured institutions to make these additional section 1727(d) payments to the FSLIC, Congress reduced the ratio of stock which members of a Federal Home Loan Bank were required to hold against their "unpaid loan principal" from two to one percent. It was contemplated that "[f]or most institutions, this prepayment requirement [i.e., section 1727(d) payments] would be approximately offset by reducing the stock the institution must purchase in its Federal home loan

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ever, an inadequacy of working capital." This witness went on to explain that the FSLIC does not "sit idly by, wait for a loss to occur, and then pay out insurance * * *", but has authority to take steps, such as the making of loans to institutions in danger of failing, which "may involve substantial cash disbursements without ultimate loss to the Corporation."

The savings and loan industry supported Public Law 87-210, see S. Rept. No. 778, 87th Cong., 1st Sess., pp. 5, 12–13, in line with its "longstanding position" that savings and loan associations should finance "their Insurance Corporation" rather than "rely on taxpayer funds for this purpose." See S. Rept. No. 378, 89th Cong., 1st Sess., pp. 71–72 (1965).

bank." See H. Rept. No. 823, *supra,* p. 2; S. Rept. No. 778, *supra,* pp. 1–2. In essence, then, Public Law 87–210 provided that funds which would otherwise have gone into the capital structure of the Federal Home Loan Banks, which already had "more than sufficient [amounts invested in capital stock] to meet the criterion of adequate capitalization," see Hearings, *supra,* p. 9, would be channeled instead to the FSLIC's Secondary Reserve, which is itself essentially a capital account, though more temporary in nature. Moreover, to the extent that an insured institution is required to purchase additional stock in its Federal Home Loan Bank, its section 1727(d) payment to the FSLIC is reduced by the amount of stock so purchased. Clearly, if the section 1727(d) payments represented actual insurance premiums needed by the FSLIC to meet its expenses and losses, rather than merely a capital cushion for the FSLIC, this arrangement would not have been feasible. The fungibility of capital stock payments to the Federal Home Loan Bank and section 1727(d) payments to the FSLIC under Public Law 87–210 strongly suggests that Congress thought of both as serving roughly the same purpose.

The conclusion then, is inescapable that section 1727(d) payments result in the creation of an asset in the nature of a capital investment which should, however, eventually be used to provide insurance coverage in future years, and that for Federal income tax purposes at least, such payments must be capitalized and deducted from gross income only in the years and to the extent actually used to provide such insurance coverage or actually drawn upon to meet losses. Regs. section 1.461–1(a), *supra.* Nor are we convinced by petitioner's argument and the testimony of its expert

witnesses, that even as a matter of general accounting practice a section 1727(d) payment should be written off immediately because of uncertainty as to whether and when it will benefit the insured institution. We have already demonstrated that, for all practical purposes, these payments will definitely be used to discharge the obligation of the insured institution to pay regular annual premiums in future years, assuming it has not previously transferred its pro rata share of the Secondary Reserve or received a cash payment in respect thereof from the FSLIC. Even the years in which the Secondary Reserve will be available for such use are not wholly a matter of conjecture, for the Office of the Comptroller of the FSLIC has made projections in this regard, showing, inter alia, that the aggregate of the Primary and Secondary Reserves of the FSLIC will equal or exceed two percent of the FSLIC's potential liabilities by 1970, and will thereafter be available for payment of regular annual premiums in subsequent years (except those in which the aggregate of the reserves falls below 1¾ percent of the FSLIC's potential liabilities, as disclosed in the projection) until 1995, when the Primary Reserve is expected to equal or exceed the two percent ratio by itself.[8] See Findings of Fact, p.—, *supra*.

[8] The projections made by the FSLIC are, of course, based on a number of assumptions, and are not infallible. Still, they have been proven relatively accurate for the first five years since the enactment of Public Law 87-210, and, in its annual report for 1966, the FHLB Board (which administers the FSLIC) stated that it expected the aggregate of the Primary and Secondary Reserves to reach the two percent level by 1971, as compared to the prediction of 1970 in the original FSLIC estimate. To be sure, these estimates will not allow an insured institution to compute with pinpoint accuracy the years in which its section 1727(d) payments will be used to provide insurance coverage, but they do at least allow it to make a rough approximation.

Moreover, the fact of the matter is that both the California Savings and Loan Commissioner and the FHLB Board require that section 1727(d) payments be capitalized and shown on the financial statements of insured institutions as an asset, to be expensed only in the years in which actually used to satisfy the insured institution's obligation to pay a regular section 1727(b) insurance premium. It is, of course, well established that methods of accounting prescribed by regulatory agencies are not controlling for Federal tax purposes, *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 562; *Bellefontaine Federal Savings and Loan Association,* 33 T.C. 808, 811–812, but where, as here, the accounting treatment prescribed for a particular expenditure appears to be prompted not by any particular statutory or regulatory requirements (indeed, it would seem that agencies charged with the supervision of financial institutions would be quite anxious that the assets and net income of such institutions not be overstated) but rather to be based upon sound accounting principles, it should not be wholly disregarded. Furthermore, the financial statements of both petitioner and its parent, the First Lincoln Financial Corporation reported the section 1727(d) payments here in issue as assets, not expenses, and the firm of certified public accountants which audited such financial statements was able to state, in the Accountant's Report preceding such financial statements, that they presented fairly the financial position of petitioner and its parent "in conformity with generally accepted accounting principles * * *."

We are aware that the same issue that confronts us here was raised, and recently decided in favor of the taxpayer, in *First Federal Savings & Loan Ass'n. of St. Joseph* v. *United States,* 22 AFTR 2d 5238

(W.D. Mo. 1968),[9] the only case in which the issue herein has been adjudicated. The District Court there refused to follow Rev. Rul. 66–49, 1966–1 C.B. 36, in which it was stated that section 1727(d) payments were not deductible as ordinary and necessary expenses. The court held that section 1727(d) payments were deductible in the year of payment, relying on the fact that insured institutions are "subject to the basic liability" to make such payments, that the funds were "paid with respect to insurance coverage and * * * [were] based, to a certain extent, upon the risk of loss," and "of even more significance," upon the fact that such payments "were subject to being completely consumed in the event of a loss." We have already expressed our opinion on these matters, and, being of the view that section 1727(d) payments are nondeductible capital expenditures, we respectfully decline to follow the holding of the District Court. Though we prefer to rest our holding upon the reasons set forth in this opinion, we do agree with the conclusion reached in Rev. Rul. 66–49 that section 1727(d) payments are not ordinary and necessary expenses in the year of payment and are not deductible until they are used to pay regular premiums or losses, or the possibility of their return to the institu-

[9] That case involved a Federal savings and loan association which, unlike petitioner, a state-chartered association, was required and not merely permitted to insure its accounts with the FSLIC. Thus, it did not have the option, available to petitioner, of terminating its insured status without going into liquidation, while petitioner, theoretically at least, could cease being an insured institution of the FSLIC, receive its pro rata share of the Secondary Reserve in cash, and still remain in business. We need not discuss further whether this alternative was open to petitioner as a practical matter, and do not express any opinion as to the significance of this distinction, for our disagreement with the District Court's opinion goes to the more basic issue of the inherent nature of the section 1727(d) payment.

tions is otherwise precluded. Rev. Rul. 66–49, *supra*, 1966–1 C.B. 36, 37.[10]

Because of the unusual nature of the section 1727(d) payments in issue, the remaining cases and rulings cited by both petitioner and respondent are, for the most part, distinguishable on their facts. Thus, cases cited by petitioner for the proposition that an ordinary and necessary business expense is not rendered nondeductible because there remains after payment a contingent possibility of future recovery, e.g. *Alleghany Corporation*, 28 T.C. 298, 305; *Electric Tachometer Corp.*, 37 T.C. 158; and cf. I.T. 2764, XIII–1 C.B. 45, IT. 3632, 1943 C.B. 114,[11] Rev. Rul.

[10] It was also held in Rev. Rul. 66–49 that the annual return credited to each insured institution on amounts in its pro rata share of the Secondary Reserve does not constitute taxable income to an insured institution on the cash basis until actually or constructively received by it, either by way of refund or by its use to discharge the insured institution's obligation to pay annual premiums. Petitioner, while of course not disparaging the Commissioner's position on this matter, claims it is inconsistent with his position on the deductibility of the section 1727(d) payments. The question of when this annual "return" must be included in the income of a cash basis taxpayer is not now before us, and we express no opinion thereon. We do note, however, that the position we take here, that section 1727(d) payments are nondeductible capital expenditures, is no inconsistent with the Commissioner's position as to the time for inclusion of the annual return on income.

[11] I.T. 2764, replied upon by petitioner, was declared obsolete in Rev. Rul. 68–100, 1968–9 I.R.B. 24. It involved payments made to a temporary insurance fund set up by the Federal Deposit Insurance Corporation in the first days of its creation, and relied upon G.C.M. 8474 IX–2 C.B. 281 which was shortly thereafter revoked by the Commissioner. G.C.M. 13290, XIII–2 C.B. 313. See text concerning the Texas State Depositor's Guaranty Fund, p. —, *infra*. I.T. 3632, another ruling cited above upon which petitioner relies, cited as its only authority I.T. 2764. Both I.T. 2764 and I.T. 3632, however, are also distinguishable on their facts, as is noted above.

62, 1953–1 C.B. 71, are of no help to petitioner here since it failed to establish the necessary initial foundation required by these cases; i.e., that the amount of $882,636.86 paid by it to the FSLIC in 1963 pursuant to section 1727(d) constituted an ordinary and necessary expense of that year. Cf. *Harry W. Williamson*, 37 T.C. 941, 944. Nor, on the other hand, were these payments merely security deposits in the nature of a reserve for contingent liabilities as suggested by respondent. Cf. *Spring Canyon Coal Co.* v. *Commissioner*, 43 F. 2d 78 (C.A. 10), certiorari denied 284 U.S. 654; *Wayne Title & Trust Co.* v. *Commissioner*, 195 F. 2d 401 (C.A. 3); *Wolfington Body Co.* v. *Smith*, 99 F. Supp. 788 (E.D. Pa.). Compare *Weber Paper Company* v. *United States*, 204 F. Supp. 394 (W.D. Mo.) affirmed, 320 F. 2d 199 (C.A 8), with Rev. Rul. 60–275, 1960–2 C.B. 43. Perhaps most closely approximating the situation in this case are those cases and rulings involving payments made by Texas State banks during the 1920's to the Texas State Depositor's Guaranty Fund, which, because they shed some light on the section 1727(d) payments involved herein, we now set forth in some detail.

Texas statutes required every state bank to protect its depositors either by a bond or policy of insurance, or by becoming a contributor to the Depositor's Guaranty Fund. If the latter method was elected, the bank was required to make annual contributions to the Fund based upon its average deposits, one-fourth in cash to the State Treasury on which the bank was entitled to interest, though not payable until its liquidation or withdrawal from the Fund, and three-fourths as a deposit on its books to the credit of the State Banking Board. These "regular contributions" were to continue until the Fund contained five million dollars. If a contributing bank failed, whatever money

was needed to pay its depositors was taken from the Fund, which was then immediately reimbursed by a special cash assessment levied on the contributing banks. Such "special assessments" could not exceed two percent of a bank's total average daily deposits in any one year, so that, in any year in which losses exceeded this amount, recourse was had to the Fund itself, and the "regular contributions" to the Fund would resume until it again reached five million dollars. Each participating bank's prorata share of the Fund was returnable to it upon its withdrawal from the Fund or upon its liquidation.

The proper treatment to be accorded the regular contributions to the Fund for Federal income tax purposes became a matter of some controversy. The Bureau of Internal Revenue first held that they were deductible as "necessary business expenses," I.T. 1258, I-1 C.B. 281, but soon revoked this ruling in I.T. 2208, IV-2 C.B. 81. The position was then taken that the contributions were not deductible since they "remain assets of such participating banks. Each participating bank retains at all times an interest in the fund equal to the unexpended portion of its contributions thereto, the amount whereof is readily determinable * * *". S.M. 3877, IV-2 C.B. 79. The Board of Tax Appeals did not agree with this approach, holding in *First State Bank of Bracketville,* 9 B.T.A. 975, followed in *First State Bank of Weimar,* 10 B.T.A. 396, that such contributions were deductible since they were paid "pursuant to a definite liability fixed by law." *First State Bank of Bracketville,* 9 B.T.A. 975, 980. The Bureau thereupon modified its position to conform to that of the Board of Tax Appeals. G.C.M. 8474, IX-2 C.B. 281.

However, the Board was again confronted with this issue in *Wichita State Bank & Trust Co.,* 27 B.T.A.

822. In that case, the taxpayer bank had withdrawn from the Fund and had received its pro rata portion thereof, and the issue raised was whether such amount was includible in its income. The Commissioner said it was, relying on his newly revised position on this matter following the *Bracketville* and *Weimar* cases, contending that since the regular contributions to the fund were deductible, their return to the taxpayer constituted taxable income. The Board, following its prior decisions, agreed. On appeal, in an opinion which we now think correctly disposed of this matter, the Fifth Circuit reversed the Board on this issue, holding that the regular contributions were not ordinary and necessary expenses but nondeductible capital expenditures. *Wichita State Bank & Trust Co.* v. *Commissioner,* 69 F. 2d 595 (C.A. 5). Keeping in mind the similar characteristics of these "regular contributions" and the section 1727(d) payments here in issue, the following comments of the Fifth Circuit are instructive (69 F. 2d at 596):

> * * * That fund [i.e., the permanent five million dollar Guaranty Fund] is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. * * * We think the contributions to the $5,000,000 Guaranty Fund, while made annually instead of in a lump sum, were essentially capital investments and ought to be dealt with as such.

Here the matter of the "regular contributions" was finally settled, the Commissioner indicating agreement with the Fifth Circuit's opinion by reinstating S.M. 3877. G.C.M. 13290, XIII–2 C.B. 313.

We hold that the section 1727(d) payment of $882,636.86 made by petitioner in 1963 was a nondeductible capital expenditure, that the Commissioner correctly disallowed a deduction for this sum, and that the deficiency determined in petitioner's income tax for 1963 in respect of that disallowance was proper.

Petitioner has made an alternative argument that the Commissioner's attempt to assess and collect the deficiency here violated its constitutional rights under either Article II, section 3 (directing the President to "take care that the laws be faithfully executed") or the Fifth Amendment to the Constitution (the due process clause). Petitioner relies on the fact that in the *First Federal Savings & Loan Ass'n. of St. Joseph* case, discussed above, a tax refund suit in which the taxpayer savings and loan association sued to recover taxes which it alleged were erroneously paid for 1963, 1964 and 1965 due to its failure to deduct section 1727(d) payments made in those years, the Government tried to settle by offering to pay the amount sought by the taxpayer and to dismiss the action with prejudice, though it did not wish the terms of the settlement to be included in the final stipulation. It should be noted that the taxpayer refused this offer, and the District Court went to extraordinary lengths in ruling that the refund suit had not become moot. The District Court thereupon adjudicated the issue on the merits in the taxpayer's favor. Petitioner nevertheless contends that the mere fact that the offer of settlement was made to the taxpayer in the *St. Joseph* case is fatal to the determination of the deficiency herein on Constitutional grounds. We think that the point is without merit.

The position taken by the Commissioner in this case in respect of section 1727(d) payments made to the

FSLIC is the same as that in Rev. Rul. 66–49, published in Cumulative Bulletin 1966–1, p. 36. We have carefully examined that position, as it relates to the facts of this case, and have found the deficiency determined by the Commissioner in petitioner's income tax for 1963 was justified by the provisions of the Internal Revenue Code of 1954. We cannot and will not go further and examine the Commissioner's reasons and motives for determining the deficiency in this case and defending his position in response to the petition for a redetermination filed by petitioner in this Court. See *Charles Crowther,* 28 T.C. 1293, 1301, affirmed 269 F. 2d 292, 293 (C.A. 9). Petitioner has no ground to object merely because some other taxpayer may have been offered a windfall as a result of the Government's litigation strategy. Whatever may have been the Government's litigation strategy in attempting to dispose of the *St. Joseph* case, it is not a matter about which the petitioner herein has any standing to complain. The history of litigation over the years has been marked by efforts of private litigants as well as the Government to select test cases in such manner as may be thought to further their respective best interests, and the refusal to press some other case has never been thought to create any rights in favor of parties to a case where similar concessions have not been made. Petitioner has been accorded due process of law in the review of the deficiency determined against it by the Commissioner herein and the fact that it has not been offered a windfall, if indeed the offer of settlement in the *St. Joseph* case was such, does not rise to the level of an infringement of its constitutional rights.

Reviewed by the Court.

Decision will be entered for the respondent.

APPENDIX B

United States Court of Appeals for the Ninth Circuit

No. 23,923

LINCOLN SAVINGS AND LOAN ASSOCIATION, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

February 3, 1970

On Appeal from the Decision of the Tax Court of the United States

Before ELY and HUFSTEDLER, *Circuit Judges,* and THOMPSON,* *District Judge.*

THOMPSON, *District Judge:*

We are asked to review a determination by the Tax Court. A deduction of $882,636.86 from Apellant's gross income for 1963 was contested. The Tax Court held that Appellant's payment, made for inclusion in the Secondary Reserve Account of the Federal Savings and Loan Insurance Corporation (FSLIC) resulted in the acquisition of a capital asset rather than constituting an ordinary and necessary business expense deductible in the year paid as contemplated by 26 U.S.C. § 162(a).

Jurisdiction and scope of review are governed by 26 U.S.C. § 7482.

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* Hon. Bruce R. Thompson, United States District Judge, Reno, Nevada, sitting by designation.

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The Tax Court, in its published opinion, Lincoln Savings and Loan Association, Petitioner, v. Commissioner of Internal Revenue, Respondent, Docket No. 325–67, 51 T.C. 82, made a comprehensive and accurate statement of the facts. Also in that opinion, as well as in *First Federal Savings and Loan Association of St. Joseph* v. *United States,* 288 F. Supp. 477 (W.D. Mo. 1968), and in *Washington Federal Savings and Loan Association of Miami Beach* v. *United States,* 304 F. Supp. 1072 (S.D. Fla. 1969), we find extensive expositions of the applicable statutes and legislative history. Whatever may be said in favor of the proliferation of the printed legal word which has attended the effort of judicial draftsmen to make each opinion an integrated, comprehensive whole, in this situation, where we are concerned with unique and specialized statutory provisions having a tax impact only on one particular segment of the economy, the savings and loan institutions, we discern no advantage in repeating all the arguments, contentions and responses made by the parties here which have been thoroughly considered in the referenced opinions. Neither is it useful to restate the facts in detail, a statement which required twenty-three typewritten pages of the Tax Court opinion. We are writing with the assumption that the reader is familiar with the opinions to which reference has been made.

The taxpayer here is a state-chartered savings and loan association. The *St. Joseph* and *Miami Beach* opinions, *supra,* concerned federal savings and loan associations. The federal institutions are required by law to insure deposits with FSLIC and so to make the premium payments to the Secondary Reserve. A

state-chartered institution is not required by law to insure deposits with FSLIC. In this respect, the cases differ. The Tax Court, however, found as a fact that "in the opinion of its (taxpayer's) management loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors", and quite properly refused to distinguish the *St. Joseph* case on account of the difference we have noted. We deem both the *St. Joseph* and *Miami Beach* opinions to be persuasive authority in support of the contentions of this taxpayer and we adopt the cogent arguments in those opinions by reference, without repetition.

The Tax Court opinion approves Revenue Ruling 66-49 (Internal Revenue Bulletin, C.B. 1966-1, January-June 1966, p. 36). The headnote summarizes the ruling.[1] Such rulings, unlike Treasury Regulations, do not have the force of law and are at most merely

[1] "The additional premium prepayments which an insured savings and loan institution is required to pay to the Federal Savings and Loan Insurance Corporation under the provisions of section 404 of the National Housing Act, as amended, are not deductible when paid and may be deducted only when any possibility of their return is precluded. With respect to an accrual basis institution, earnings on such premiums are not includible in the gross income of that institution until such time as the earnings are no longer available for losses of the FSLIC. With respect to a cash basis institution, earnings on such premiums are includible in the gross income of the institution credited therewith only when such earnings are used to pay its obligations or become available to that institution without substantial restriction or limitation." Internal Revenue Bulletin, C.B. 1966-1, January-June 1966, p. 36.

persuasive.[2] We think the revenue ruling is wrong.

The question presented is whether the premium payments under 12 U.S.C. § 1727(d), which the taxpayer made into the Secondary Reserve of FSLIC, were deductible as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 26 U.S.C. § 162(a). The tax Court said no, and characterized the expense as a nondeductible capital expenditure. 26 U.S.C. § 262. In doing so, the Court emphasized the way the Secondary Reserve was accounted for and managed by FSLIC. It pointed out that Section 1727(d) payments "are not considered as income by the FSLIC"; are used "only for losses of the corporation * * * to such extent as other accounts * * * are insufficient"; that the Secondary Reserve account is "rather like a capital account"; that the Secondary Reserve is "part of a pool of capital available to the FSLIC * * * in the event of emergency. We think the emphasis upon the treatment of the receipt by the payee, FSLIC, is mistaken and that in determining whether an expense is an ordinary and necessary expense of doing business, the focus should be on the taxpayer and the taxpayer's business, not on what the payee does with the money paid. This is not to say that rights retained by the taxpayer are to be ignored.

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[2] *Macey's Jewelry Corp.* v. *United States*, 387 F. 2d 70, 72 (5th Cir. 1967); *United States* v. *Bennett*, 186 F. 2d 407, 410 (5th Cir. 1951); cf. *Skidmore* v. *Swift & Co.*, 323 U.S. 134 (1944); *United States* v. *Jefferson Co. Bd. of Educ.*, 372 F. 2d 836, 858 (5th Cir. 1966); *Tandy Leather Co.* v. *United States*, 347 F. 2d 693 (5th Cir. 1965); *Norton Mfg. Corp.* v. *United States*, 288 F. Supp. 829, 835 (N.D. Ill. 1968); *Pauley* v. *United States*, 63 U.S.T.C. para. 9280 (S.D. Cal. 1963); *Kaiser* v. *United States*, 262 F. 2d 367, 370 (7th Cir. 1958), aff'd, 363 U.S. 299 (1960).

Obviously, the payment made to the Secondary Reserve has hybrid characteristics. If this were not so, there would be no lawsuit. The tax impact of the payment must depend upon whether it is more like a capital investment or a business expense.

In opting for the business expense treatment of this expenditure, we first consider whether the revenue ruling to the contrary is inconsistent with the annual accounting concept of income determination and income tax assessment. We think that it is. The importance of this concept was emphasized in *Security Mills Co.* v. *Comm'r,* 321 U.S. 281 (1944), where the Court said:

> "The rationale of the system is this: 'It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.'
>
> "This legal principle has often been stated and applied. The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount."

To treat the payments of premiums to the Secondary Reserve as the acquisition of a capital asset is a departure from the basic concept of accounting for receipts and disbursements in the year when made (on cash basis accounting). So, it is not just a matter of choosing one treatment or the other. On the contrary, persuasive reasons should appear to justify the departure.

The Commissioner's ruling also ignores another of the most fundamental concepts of federal income taxation. Both federal income taxation and generally accepted principles of the accounting profession assume that a corporate taxpayer is a "going concern" and will continue indefinitely. Ascertainment of revenue at the end of the accounting period does not hinge upon determination of liquidation value of closing inventories, nor is appreciation or depreciation in value of balance sheet assets considered. This concept is so basic that Congress felt compelled to provide a specific exemption for corporations formed or acquired primarily for liquidation. 26 U.S.C. § 341 (1964). Accordingly, to give consideration to the possibilities of reimbursement because of liquidation or receivership is inconsistent with this principle. The possibility of reimbursement by the taxpayer's voluntary act of termination of coverage is in the same category. The Tax Court found that Appellant's management believed that termination of insurance would cause mass withdrawal by its depositors and, ultimately liquidation. The Court also found that all but an insignificant portion of the savings and loan industry thought it necessary to have insurance coverage. Therefore, the practical realities require the conclusion that termination of coverage is not a proper consideration in determining the finality of the disbursement in issue. Termination here is deemed tantamount to liquidation or receivership.

We also believe that the revenue ruling is inconsistent within itself. It declares (1) that the payments to the Secondary Reserve were not deductible until any possibility of their return was precluded; also (2) that earnings on the Secondary Reserve are

taxable to the taxpayer only when they become available to it without substantial restriction or are paid out for its benefit. When we consider that under the "claim of right" doctrine, there must be an impossibility of even constructive possession to defeat taxation of income and that a non-contractual obligation of repayment will not defeat it (*James* v. *United States,* 366 U.S. 213 (1961)) in the context of the "all events" test fixing the accounting period for the allowance of deductions as the one in which all events had occurred which fixed the amount and the fact of the liability (*United States* v. *Anderson,* 269 U.S. 422 (1926); *Dixie Pine Co.* v. *Comm.,* 320 U.S. 516 (1944); *United States* v. *Consolidated Edison Co.,* 366 U.S. 380 (1961)), there is an incongruity in a ruling that the income credited to the Secondary Reserve allocated to the taxpayer was not then taxable because of the restrictions on its use, while at the same time these same restrictions precluded deduction of the premium payments as business expenses. If there were so many restrictions on the funds paid to FSLIC that the income derived therefrom was not even constructively received and was not taxable when credited, *a fortiori* these same restrictions on reimbursement or recapture of the funds made the payment final and deductible in the year it was made. All events had occurred which fixed the amount and the fact of the liability.

From the point of view of Congressional policy, we should observe that the rule of *United States* v. *Consolidated Edison Co.,* 366 U.S. 380 (1961), holding that a contested tax liability paid under protest could be deducted not in the year of payment but only in the year liability became fixed and final has been reversed

by Congress. 26 U.S.C. § 461(f).[3] The Senate Report, in explanation of the 1964 amendment, states, in part: "The objective of the reporting of items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws contain a number of adjustments designed to accomplish this result. Your committee believes that allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled." U.S. Cong. & Adm. News, 88th Cong., 2nd Sess., p. 1773.

This reaffirmation of basic Congressional policy obviously is not specific authority for our particular problem. It, nevertheless, should incline us to recognizing deductions in the year payment is made rather than to postpone them because of contingent and sometimes quite illusory possibilities of recapture.

The payments made by this taxpayer into the Secondary Reserve of FSLIC meet the tests of necessary business expenses. The expense is "appropriate and helpful" for the "development of the taxpayer's busi-

[3] "(f) Contested liabilities.—If—

"(1) the taxpayer contests an asserted liability,

"(2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

"(3) the contest with respect to the asserted liability exists after the time of the transfer, and

"(4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year),

"then the deduction shall be allowed for the taxable year of the transfer." 26 U.S.C. § 461(f).

ness." *Commissioner* v. *Tellier,* 383 U.S. 687 (1966). To say that they are also "ordinary" is to beg the question which faces us inasmuch as "ordinary" is a qualification designed to exclude expenditures "in the nature of capital expenditures which, if deductible at all, must be amortized over the useful life of the asset." *Commissioner* v. *Tellier, supra.* These payments, nevertheless, fulfill our conception of an "ordinary" business expense. It is a recurring annual expense geared primarily to acceleration of the taxpayer's business; that is, the increase in the accounts of the insured members. It is an expense which, from a practical point of view, has to be paid to stay in business. It must be paid regardless of whether income is available for the purpose. The obligation is not associated with an increase of the taxpayer's income. On the contrary, it is generated because of an increase in the taxpayer's liabilities. When these identifying brands are present, it is practical and essential that the character of the expenditure as an ordinary, as well as necessary, business expense be recognized. Otherwise, the impact of the tax may destroy the business.

For the reasons stated, in addition to those articulated in the *St. Joseph* and *Miami Beach* cases, *supra,* we deem Revenue Ruling 66–49 to be unreasonable. The decision of the Tax Court is reversed.

HUFSTEDLER, *Circuit Judge:*

I respectively dissent. There is nothing in the record to support the majority's statement that the payments are a "recurring annual expense." To the contrary, the Tax Court found that in all likelihood the section 1727(d) payments would be required for a duration of only a few years (until approximately 1971) and that thereafter the suspension provisions of 1727(g) would be in effect. The taxpayer's pro rata share of the Sec-

ondary Reserve would then be used to discharge its premium obligations under section 1727(b). "[F]or all practical purposes, [the section 1727(d)] payments will definitely be used to discharge the obligation of the insured institution to pay regular annual premiums in future years, assuming it has not previously transferred its pro rata share of the Secondary Reserve or received a cash payment in respect thereof from the FSLIC." (51 T.C. at 102).

For this and the other reasons expressed by the unanimous Tax Court, I would affirm on the ground that the payments are "in the nature of a prepayment with respect to future premiums," and are not therefore deductible as an ordinary and necessary business expense in the year made.

APPENDIX C

United States Court of Appeals for the Ninth Circuit

No. 23923 (Tax Ct No. 325–68)

LINCOLN SAVINGS AND LOAN ASSOCIATION, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

Upon Petition to Review a Decision of The Tax Court of the United States

(Filed and entered Feb. 3, 1970)

JUDGMENT

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed.

APPENDIX D

United States Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Wednesday,

March 18th, 1970

Order Denying Petition for Rehearing

Before: ELY and HUFSTEDLER, *Circuit Judges,* and THOMPSON, *District Judge.*

On consideration thereof, and by direction of the Court, *It is ordered* that the petition of appellee filed February 20, 1970 and within time allowed therefor by rule of court, for a rehearing of above cause be, and hereby is denied, and rejecting suggestion for rehearing en banc.

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * *

Treasury Regulations on Income Tax (~~26 C.F.R.~~):

§ 1.461–1. *General rule for taxable year of deduction.*

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may deductible only in part,

for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which

extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461–2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

* * * * *

400-943—70——6

APPENDIX F

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. 6. [as amended by Sec. 509 of the National Housing Act, c. 847, 48 Stat. 1264, and Sec. 2 of the Act of June 27, 1950, c. 369, 64 Stat. 257, 12 U.S.C. (1958 ed.) 1426].

* * * * *

(c) The original stock subscription for each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the aggregate of the unpaid principal of the subscriber's home mortgage loans, but not less than $500. The board shall from time to time adjust the amount of stock held by each member to that, as nearly as possible, such member shall at all times have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the preceding sentence (but not less than $500). If the board finds that the investment of any member in stock is greater than that required under this section, upon application of such member, the bank shall pay such member for each share of stock in excess of the amount so required an amount equal to the value of such stock, or, at the election of the bank, the whole or any part of the payments which would be so made shall be credited upon the indebtedness of the member to the bank. In either such event, stock equal in value to the amount of the payment or credit, or both, as the case may be, shall be surrendered and canceled. No share of stock shall be surrendered and canceled if the effect of such surrender and cancellation would be to violate the provisions of section 10(c) requiring the amount of stock held by such member to equal at least one-twelfth of the outstanding advances to such member.

* * * * *

(l) Within one year after the enactment of this subsection, each member of each Federal Home Loan Bank shall acquire and hold and thereafter maintain its stockholding in an amount equal to at least 2 per centum of the aggregate of the unpaid principal of such member's home mortgage loans, home-purchase contracts, and similar obligations, but not less than $500. Such stock in excess of the amount hereby required may be purchased from time to time by members and may be retired from time to time as heretofore. One year after the enactment of this subsection, each Federal Home Loan Bank shall retire and pay off at par an amount of its stock held by the Secretary of the Treasury equivalent to the amount of its stock held by its members in excess of the amount required to be held by them by the first two sentences of subsection (c) of this section immediately prior to the enactment of this subsection and annually thereafter each Federal Home Loan Bank shall retire an amount of such Government stock equivalent to 50 per centum of the net increase of its stock held by members since the last previous retirement: *Provided,* That none of such Government capital shall at any time be retired so as to reduce the aggregate capital stock, reserves, surplus, and undivided profits of the Federal Home Loan Banks to less than $200,000,000: *Provided further,* That notwithstanding any provision of this subsection, nothing in this subsection shall limit or affect the operation of subsection (g) of this section.

National Housing Act, c. 847, 48 Stat. 1246:

SEC. 404 [as amended by Sec. 25, Act of May 28, 1935, c. 150, 49 Stat. 298, and Sec. 7 of the Act of June 27, 1950, 64 Stat. 259, 12 U.S.C. 1958 ed.) 1727].

(a) Each institution whose application for insurance is approved by the Corporation shall

pay to the Corporation, in such manner as it shall prescribe, a premium charge for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually until a reserve fund has been established by the Corporation equal to 5 per centum of all insured accounts and creditor obligations of all insured institutions; except that under regulations prescribed by the Corporation such premium charge may be paid semiannually. If at any time such reserve fund falls below such 5 per centum, the payment of such annual premium charge for insurance shall be resumed and shall be continued until the reserve is brought back to such 5 per centum. For the purposes of this subsection, the amount in all accounts of insured members and the amount of creditor obligations of any institution may be determined from adjusted statements made within one year prior to the approval of the application of such institution for insurance, or in such other manner as the Corporation may by rules and regulations prescribe.

(b) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except that the total amount so assessed in any one year against any such institution shall not exceed one-eighth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

* * * * *

APPENDIX G

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. F. [as amended by Sec. 1 of the Act of September 8, 1961, P.L. 87-210, 75 Stat. 482, 12 U.S.C. 1426].

* * * * *

(c)(1) The original stock subscription of each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the subscriber's aggregate unpaid loan principal, but not less than $500. The bank shall annually, as of the close of the calendar year, adjust, at such time and in such manner and upon such terms and conditions as the Federal Home Loan Bank Board may by regulations or otherwise prescribe, the amount of stock held by each member so that such member shall have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the next preceding sentence (but not less than $500). If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire the stock of such member in excess of the amount so required. Said Board, in its discretion, may, by regulations or otherwise, provide for adjustments in amounts of stock to be issued or retired in order that stock may be issued or retired only in entire shares.

* * * * *

National Housing Act, c. 847, 48 Stat. 1246:

SEC. 402. [as amended by Sec. 6 of the Act of June 27, 1950, c. 369, 64 Stat. 259, 12 U.S.C. 1725].

* * * * *

(i) The Corporation is authorized to borrow from the Treasury, and the Secretary of the Treasury is authorized and directed to loan to the Corporation on such terms as may be fixed by the Corporation and the Secretary, such funds as in the judgment of the Home Loan Bank Board are from time to time required for insurance purposes, not exceeding in the aggregate $750,000,000 outstanding at any one time, and the Corporation hereafter shall not exercise its borrowing power under the first sentence of subsection (d) of this section for the purpose of borrowing money from any other source: *Provided,* That each such loan shall bear interest at a rate determined by the Secretary of the Treasury, taking into consideration the current average rate on outstanding marketable obligations of the United States as of the last day of the month preceding the making of such loan: *Provided further,* That nothing in this subsection shall prevent the Corporation from issuing debentures in accordance with the provisions of subsection (b) of section 405. For the purposes of this subsection the Secretary of the Treasury is authorized to use as a public-debt transaction the proceeds of the sale of any securities hereafter issued under the Second Liberty Bond Act, as now or hereafter in force, and the purposes for which securities may be issued under the Second Liberty Bond Act, as now or hereafter in force, are hereby extended to include such loans. Any such loan shall be used by the Corporation solely in carrying out its functions with respect to such insurance. All loans and repayments under this subsection shall be treated as public-debt transactions of the United States.

SEC. 404. [as amended by Secs. 3, 4, 5, and 6 of the Act of September 8, 1961, *supra*, 12 U.S.C. 1727].

(a) The Corporation shall establish a Primary Reserve which shall be the general re-

serve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) and the credits made pursuant to the first sentence of subsection (e).

(b)(1) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually, except that under regulations prescribed by the Corporation such premium may be paid semiannually.

(2) If, at the close of any December 31, the Primary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions as of such close, no premium under paragraph (1) of this subsection shall be payable by any insured institution with respect to its premium year beginning during the year commencing on May 1 next succeeding such December 31, except that the foregoing provisions of this sentence shall not be applicable to any insured institution with respect to any of the twenty premium years beginning with the premium year commencing with the date on which such certificate is issued.

(3) The Corporation is authorized to prescribe such rules and regulations as it may determine to be necessary or appropriate to accomplish the purposes and provisions of this subsection.

(c) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except

that the total amount so assessed in any one year against any such institution shall not exceed one-eighth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

(d) Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 6 of the Federal Home Loan Bank Act and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve: *Provided*, That in the case of an insured institution which was not an insured institution at the beginning of such next preceding calendar year the 2 per centum aforesaid shall be 2 per centum of the net increase in all accounts of its insured members during that part of said calendar year which begins with the close of the day on which such institution becomes an insured institution and the amount deducted from such 2 per centum under the foregoing provisions of this sentence shall not exceed one-half of such 2 per centum as calculated in accordance with this proviso. The Federal Home Loan Bank Board shall by regulations or otherwise provide for the furnishing to the Corporation of all necessary information with respect to Federal Home Loan Bank stock.

(e) The Corporation, in accordance with such regulations as it may prescribe, shall credit to the Secondary Reserve, as of the close of each calendar year a return on the outstanding balances of the Secondary Reserve during such calendar year, as determined by the Corporation, at a rate equal to the average annual rate of return to the Corporation during the year ending at the close of November 30 of such calendar year, as determined by the Corporation, on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States. Except as provided in subsections (f) and (g), the Secondary Reserve shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses. No right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation, transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined.

(f) If (i) the status of an insured institution as an insured institution is terminated pursuant to any provision of section 407 or the insurance of accounts of an insured institution is otherwise terminated, (ii) a conservator, receiver, or other legal custodian is appointed for an insured institution under the circumstances and for the purpose set forth in subdivision (d) of section 401, or (iii) the Corporation makes a determination that for the purposes of this subsection an insured institution has gone into liquidation, the obligation of such institution to

make prepayments under subsection (d) of this section, including any prepayments as to which such institution is obligated at the time of such termination, appointment, or determination, shall cease, and the Corporation shall pay in cash to such institution its pro rata share of the Secondary Reserve, in accordance with such terms and conditions as the Corporation may prescribe by regulations or otherwise, or, at the option of the Corporation, the Corporation may apply the whole or any part of the amount which would otherwise be paid in cash toward the payment of any indebtedness or obligation, whether matured or not, of such institution to the Corporation, then existing or arising before such payment in cash: *Provided,* That such payment or such application need not be made to the extent that the provisions of the exception in the last sentence of subsection (e) are applicable. The Corporation in its discretion may provide by regulations or otherwise for the reinstatement in whole or in part, upon such terms and conditions as to payment or otherwise as it may prescribe, of the pro rata share of an institution in the Secondary Reserve in the event that such status or such insurance is restored by action of the Corporation or of a court in reversing or setting aside such termination, or in the event that, after such appointment or such determination, an institution is restored to operation as an insured institution, and for the payment, waiver, or other treatment in whole or in part of any prepayments which, in the absence of the first sentence of this subsection, would have accrued under subsection (d) or would be payable thereunder.

(g) If, at the close of any December 31, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions but the Primary Reserve does not equal or exceed such 2 per centum, no insured institution shall be obligated to make any prepayment under subsection (d) during the year beginning with May 1 next succeeding such close, and each insured institution's pro rata share of the Secondary Reserve shall be used, to the extent available, to discharge such institution's obligation for its premium under subsection (b) for the premium year beginning in such year; and the suspension of obligation to make such prepayments and the use of such pro rata shares as provided in this sentence shall continue unless and until the next sentence or the last sentence of this subsection shall become operative. If, at the close of any December 31 occurring before the last sentence of this subsection shall become operative, the aggregate of the Primary Reserve and the Secondary Reserve is not at least equal to 1¾ per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions, (i) the obligation of insured institutions to make prepayments under subsection (d) shall resume on May 1 next following such December 31 and shall continue unless and until the first sentence or the last sentence of this subsection shall become operative, and (ii) the use of any insured institution's pro rata share of the Secondary Reserve under the first sentence of this

subsection shall terminate with respect to its premium under subsection (b) for the premium year beginning during the calendar year commencing on May 1 next succeeding such December 31, and such termination shall continue unless and until the first sentence of this subsection shall become operative. If, at the close of any December 31, the Primary Reserve equals or exceeds such 2 per centum, the Corporation shall, at such time (which shall be the same for all insured institutions and shall not be later than May 1 next succeeding such close) and in such manner as the Corporation shall determine, pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not, after such time, accept or receive further prepayments under subsection (d).

U.S. GOVERNMENT PRINTING OFFICE: 1970

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

LINCOLN SAVINGS AND LOAN ASSOCIATION,

Respondent.

Brief in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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IN THE

Supreme Court of the United States

October Term, 1970
No. 544

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

LINCOLN SAVINGS AND LOAN ASSOCIATION,
Respondent.

Brief in Opposition to Granting a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Statement.

The petitioner's statement of the case should be corrected and amplified as follows:

a. Page 5. The statement is made that "An insured institution * * * does have an interest, however, in the Secondary Reserve, which * * * is used to pay the institution's regular insurance premiums in future years * * *." Actually, the Secondary Reserve is available to the FSLIC primarily to meet its losses, a circumstance wholly beyond the control of any insured institution; and only if and to the extent not so used

will it be available to pay the institution's regular insurance premiums.[1]

b. Page 6. Although conceding that the right, title or interest in the Secondary Reserve is not generally transferable or assignable, the petition states that the FSLIC has authority to authorize transfers in mergers, etc. Actually, the statutory language is as follows (Petition, Appendix G, p. 89):

> "No right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation, transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined."

The FSLIC has made provision *only* for transfers in mergers or consolidation,[2] and for no others. See Sec-

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[1]While this has not been a problem to date, it could become one. It is a fact of legal significance, however, in view of the petitioner's assertion (Page 12) that the Secondary Reserve payment "could be called a forced loan, but it is a loan." A "loan" carries with it an unconditional obligation to pay on demand or on a specified date a sum certain in money. The primary requirement of the payment here was to provide the FSLIC with a reserve to cover its losses; and if so used there would be no obligation whatever to repay or to use the reserve to pay the insured's regular insurance premiums in any future year.

[2]A transfer in a merger or consolidation does not result in the fruition or realization of the institution's "pro rata share of the Secondary Reserve." Instead, it merely represents a continuance in the institution's illusory interest in such reserve. With or without a merger or consolidation, the institution's protection and interest, emanating from both the Primary and Secondary reserves, will continue.

tion 563.16-2 of Rules and Regulations For Insurance of Accounts, Appendix A, page 1.

c. Pages 6 and 7. The petition states that an insured association is entitled to a cash refund in four instances:

(1) Its status as an insured institution is terminated. The Tax Court found that in the opinion of the taxpayer's management "loss of its insured status with the FSLIC would cause a mass withdrawal of savings by its depositors." (Petition, Appendix A, p. 23). This would be tantamount to a cessation of business by the institution and would then impose on the FSLIC the extreme financial burden of meeting depositors' demands from the liquidation of their accounts.

(2) A liquidating receiver has been appointed.

(3) The FSLIC determines that the association has gone into liquidation (the word "voluntary" was supplied by petitioner in its statement). The occurrence of either event (1), (2) or (3) would make the Secondary Reserve available for exactly the purpose its payment was required in the first instance, namely, insurance of savings account depositors.

(4) The Primary Reserve alone reaches two percent of insured accounts and creditors' obligations of all insured associations. The estimates of the FSLIC were that the entire Secondary Reserve would be transferred to the Primary Reserve and there would never be any cash refund to an insured institution [Ex. 13-M].

ARGUMENT IN OPPOSITION TO GRANTING THE WRIT.

1. This Is Not a Case of Substantial Fiscal Significance.

The petitioner asserts that this case is "of substantial fiscal" significance, as one reason for granting the petition for a writ of certiorari. It states (pp. 8 and 9) that claims for refund on tax on this issue amount to $72.5 million, and that statutory interest on such claims (at six percent) amounted to $22 million at August 15, 1970.

The taxpayer is at a disadvantage in this area, because the foregoing figures are not in the record and their accuracy cannot be verified.

The petition goes on to state (p. 8) that an estimated 2,000 associations have not filed claims but are free to do so within the statute of limitations. There is nothing in the record or out of it to support this assertion. We are not advised how many associations deducted the payments but without tax benefit, and hence could not file claims for refund. We do not know how many associations deducted the payments and were allowed the deductions, whether audited or not. We do not know how many associations were awarded refunds on their claims for refund. We do know that the taxpayer in *First Federal S. & L. Assn. of St. Joseph v. United States* (W. D. Mo.) 288 F. Supp. 477, was tendered a refund of the entire tax paid on this issue, but declined it, preferring a judgment on the merits; and that following a judgment in its favor the United States did not appeal the adverse decision.

Accepting as correct the petitioner's figure regarding the tax involved in pending claims for refund, we respectfully submit that no showing has been made that this is a case "of substantial fiscal" significance.

In footnotes 5 and 6 of the petition (pp. 5 and 6) it is recognized that Congress in 1969 amended the National Housing Act to eliminate "creditors obligations" in determining when the required two percent level would occur, and that such level was reached in 1969 instead of the originally-projected 1970. As a consequence, the petition (footnote 6, page 6) recognizes that "Beginning this year, the Secondary Reserves are being used to meet the insured institutions' obligations for Section 404(b) payments. FSLIC has not yet prepared a new projection based on the 1969 amendment, but there is no reason to expect that the new estimates will vary significantly from the previous estimates."

What are these "previous estimates"? They are set forth in Exhibit 13-M, and they show that the regular premiums to be paid into the Primary Reserve would be as follows:

1971	$132.3 million
1972	141.9 million
1973	151.7 million
1974	161.8 million
1975	172.3 million

(Schedule B of Exhibit 13-M)

They also show that the Secondary Reserve would be depleted by transfers to the Primary Reserve of exactly the same amounts, as follows:

1971	$132.3 million
1972	141.9 million
1973	151.7 million
1974	161.8 million
1975	172.3 million

(Schedule C of Exhibit 13-M)

In other words, the estimates of the FSLIC were that in the five years 1971 through 1975 regular insurance premiums into the Primary Reserve would aggregate $760 million, but that there would be no payments of such premiums by insured associations. There would be, instead, bookkeeping transfers of $760 million from the Secondary Reserve.

And, what is of primary importance, the petitioner concedes and contends that all the insured institutions will be entitled to income tax deductions upon such transfers, although no payments will have been made in those years by insured institutions.

The petitioner concedes that the 1969 amendment has accelerated such transfers, to begin in 1970 instead of 1971. The result is that on the FSLIC's estimates, in 1970 there will be a transfer of $132.3 million from the Secondary Reserve to the Primary Reserve, all of which on its theory will provide income tax deductions to insured institutions; and in 1971 there will be a transfer of $141.9 million.

Thus, under the petitioner's argument insured associations will be excused from paying primary premiums in 1970 and 1971 of $274 million, but they nevertheless will be entitled to deduct such amounts in computing their federal income tax liabilities for 1970 and 1971. Such deductions, assuming an effective tax rate of 50 percent, would result in a reduction of Federal revenues for 1970 of $66.1 million and for 1971 of $70.9 million, or a reduction in Federal revenues for the two years of $137 million.

Admittedly these are rough figures, and conceivably the tax involved for such two years might be less than $137 million. But the point is that the Government's

loss of revenue is going to be very substantial in this and the immediately following year—whether it refunds the $72.5 million under claims for refund for earlier years or whether the revenues for the current years are simply reduced by current deductions.

And the statutory interest cited by the petitioner is not a matter of great fiscal significance. The petitioner has had the use of the taxpayers' money (to which it was not entitled under the decisions below and of two District Courts) and in today's money market a 6 percent rate of interest is a bargain rate—less than the Treasury pays currently for borrowed funds, and assuredly less than the taxpayers could have earned with the same funds in the conduct of their businesses.

Accordingly, we respectfully submit that petitioner has made no showing that this is a case of substantial fiscal significance.

2. This Is Not a Case of Substantial Administrative Difficulties.

The petitioner's claim of "administrative difficulties" (pp. 9-11) is likewise unfounded.

The petitioner's position is that (a) taxpayers will have to take inconsistent positions by claiming the deductions in both years and (b) the Government will have to take inconsistent positions by denying the deductions in both years. But this argument is based upon a very important assumption: "if the statute of limitations runs on the later years while the earlier years are not closed by the statute of limitations" (p. 10).

The answer is that the statute of limitations will not and cannot bar a deduction at one time or another, nor can it operate to allow any taxpayer a double deduction.

In footnote 10, page 10 of the petition, it is explained that Sections 1311(b)(2)(B) and 1312(4) of the Code "lift the bar of the statute of limitations in certain cases", but the petitioner asserts in the footnote that "savings and loan associations could not safely avoid filing protective claims for the later years in reliance on Sections 1311(b)(2)(B) and 1312(4)."

The petitioner overlooks the statute that applies here, namely, Section 1312(7)(C)(iii). That provision lifts the bar of the statute of limitations when a determination determines the basis of property and in respect of any transaction which was erroneously treated as affecting such basis there occurred any of the errors specified in subparagraph (C), of which (iii) is as follows:

> "(iii) there was an erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible."

This is exactly the situation we have here, and it is exactly the reason why Congress lifted the bar of the statute of limitations so that, in controversies as to whether an item should be expensed or capitalized, the Government would not be damaged by inconsistent deduction of the same item twice nor would taxpayers be damaged by disallowance of any deduction by failing to choose the proper time for deduction.

The Senate Finance Committee stated as follows in Senate Report 1622, 83rd Congress, 2nd Session, accompanying the bill that became the Internal Revenue Code of 1954 (p. 448):

> "The type of errors described in the basis provision have been expanded to include the er-

roneous allowance of a deduction for an expense properly charged to capital account or, conversely, the erroneous charging to capital account of an expense properly deductible. Thus, if the taxpayer erroneously expenses certain costs which should be capitalized and later successfully contends that such amounts should have been added to the basis of the asset, an adjustment will be authorized under section 1311. Similarly, if the taxpayer erroneously capitalizes certain costs and the Government requires that such items be eliminated from basis, relief will be provided the taxpayer under section 1311."

Petitioner claims that the payment in question here was not an ordinary and necessary business expense but was a capital investment—the cost of a capital asset. The taxpayer contends that the payment was an expense and deducted it as such. Exactly the situation contemplated by Section 1312(7)(C)(iii).

We have only four possible situations here, and we respectfully submit that none of them poses any administrative difficulty to the Government or to the taxpayers:

1. A taxpayer, such as the taxpayer here, may have deducted the payments as they were made. If that was the correct treatment, that ends the matter. Such a taxpayer clearly would not be entitled to a later deduction when the FSLIC makes a bookkeeping entry transferring an amount from its Secondary Reserve to its so-called Primary Reserve.

2. If it is ultimately determined that a current deduction was not proper, but that a capital asset was acquired, then the taxpayer could clearly deduct the

amortization of such capital cost in later years, regardless of the statute of limitations, under Section 1312-(7)(C)(iii). So, in the meantime unnecessary protective claims for refund need not be filed, as the petitioner asserts.

3. Other taxpayers may not have claimed current deductions. They then will be entitled to later deductions under the petitioner's theory, if that theory be correct, and as to such taxpayers there is no problem.

4. But if the petitioner's theory ultimately is held to be incorrect and the later deductions are disallowed, any such taxpayer could file claim for refund for earlier years under Section 1312(7)(C)(iii), regardless of any statute of limitations.

Hence, we respectfully submit that there is no merit in the petitioner's argument that the necessary taking of inconsistent positions by taxpayers and by the Government poses "administrative difficulties". There simply is no necessity for taking inconsistent positions on either side in view of Section 1312(7)(C)(iii). This statutory provision was not in effect at the time the decision was rendered in *Wichita State Bank & T. Co. v. Commissioner*, 69 F. 2d 595, as well as other decisions in similar situations, upon which the petitioner places great reliance.

3. The "Merits" Do Not Warrant Review by This Court.

Under numeral "2" the petitioner alleges that on the merits little can be added in support of what Judge Raum said in the Tax Court (Petition, pp. 11-15). That this statement is correct is indicated by petitioner's restatement of what Judge Raum said and what the Government urged in the Ninth Circuit.

In opposition, the taxpayer can say that little can be added to what Judge Fulton said in *Washington Federal Savings and Loan Assciation of Miami Beach v. U.S.* (U.S.D.C. So. Dist. Fla., 1969), 304 F. Supp. 1072, on appeal in the Fifth Circuit. Judge Fulton had before him the Tax Court opinion and adequately refuted it in all essentials; and his opinion was virtually adopted by the Ninth Circuit. See petition, Appendix B, pages 65, 71.

But there are a few comments the taxpayer should make regarding the merits in view of the petitioner's argument:

(a) All that a savings and loan association is seeking in this litigation is the same income tax deduction that the Internal Revenue Service has allowed for decades to banks with respect to their payment of insurance premiums to the Federal Deposit Insurance Corporation. Banks pay insurance premiums to the Federal Deposit Insurance Corporation, just as savings and loan associations pay insurance premiums to the FSLIC. In the case of banks the payments build up credits for the ensuing year, just as payments by savings and loan associations may build up credit for ensuing years. But the Internal Revenue Service permits a current deduction of such payments by banks, notwithstanding benefits in subsequent years. See I.T. 2764, C.B. XIII-1, 45, and Rev. Rul. 62, C.B. 1953-1, 71.

(b) On page 12 the petitioner suggests that the secondary premium is a forced loan. This concept of an indebtedness is wholly inconsistent with the views consistently expressed by the Commissioner of Internal Revenue. It has always been the Government's position

that the basic characteristics of a loan include an unconditional promise to pay on demand or on a specified date a sum certain in money. Interestingly enough, there exists here none of these required characteristics.

(c) The petition adds a new concept to deductible expenses when it states, as a basis for disallowance of the secondary reserve premiums, that the payments "are not consumed during the taxable years in which they are made." The petitioner does not inform us what "consumption" means as it relates to the facts of this case. Presumably, petitioner is relating "consumption" with his conclusion that the taxpayer retains a "beneficial interest" in the secondary reserve payment. At least this is the implication from reading the succeeding sentence. Yet, petitioner fails to recognize that the taxpayer "retains a beneficial interest" in the payments made to the primary reserve. In fact, the beneficial interest is the same. Yet, the petitioner concedes that the Primary Reserve premium is deductible when paid (Petition, Appendix G, pp. 86, 87). The taxpayer is assured that its customers' savings accounts are insured and that, eventually, it may be relieved of making any insurance premium payments whatsoever. But that "benefit" would accrue as a result of the payment of both the primary premium and the secondary premium. It is true that when the combined reserves reach the 2 percent level the taxpayer will enjoy a benefit in not having to pay insurance premiums, but it is also true that all associations will enjoy such a benefit when the primary reserve alone reaches 2 percent, and the latter is true when an association has or has not ever paid a secondary premium. The possibility of possible future benefit is and always has been inherent in the

statutory scheme of creating an insurance reserve for the FSLIC, for premiums have always been terminable when the reserve reached a designated level. Hence, in this important respect, *i.e.*, possible future benefit, there is no fundamental distinction between the primary premium and the secondary premium.

(d) The petitioner's assertion (p. 12) that the FSLIC "is required by law to segregate that (secondary) reserve from its other assets" is erroneous. There is no segregation of assets in fact or required by law. All that occurs is that on its financial statements the FSLIC divides its reserves (on the liability side of its balance sheet) into two accounts, a Primary Reserve and a Secondary Reserve. But it is important to observe that both reserves serve exactly the same purpose, namely, a reserve for losses; and they both appear as reserves on the financial statements, not as current or long-term debts, as would the Secondary Reserve appear if it really represented a "loan" from associations.

(e) The petitioner's conclusion (p. 13, Footnote 12) that the intended function of the Secondary Reserve was to replace the permanent pool of capital represented by the Federal Home Loan Bank stock is totally unwarranted. The purchase of stock was to provide capital from which loans could be made, whereas the payments into the Secondary Reserve were for the sole purpose of providing reserves for losses, which might reasonably be expected by the FSLIC.

(f) The petition asserts (p. 14) that the decision of the Ninth Circuit repudiates a matching of costs and revenues.

Under the Government's theory, the taxpayers for 1970 should report taxable income decreased by an in-

surance premium it did not pay in that year, and that by virtue thereof its Federal income tax liability is less than it would be if it had not deducted the insurance premium which it did not pay. We can conceive of no better way to distort income than the Government suggests, both in the year of payment and in the year the payment is transferred by bookkeeping entry from the FSLIC's Secondary Reserve to its Primary Reserve. In truth and substance the money is gone in the year in which it is paid, and paid for insurance protection for its customers, and any benefit derived later from not paying a premium would be a benefit, not a subtraction from, the later year's taxable income.

(g) The petition states (pp. 14-15) that it is not surprising that Peat, Marwick & Mitchell certified the taxpayer's financial statements, in which the secondary premiums were capitalized, as being in accord with generally accepted accounting principles.

It may not be surprising, but on the other hand such certification does not necessarily make it right. The Internal Revenue Service would be the last to contend that an opinion of a certified public accountant necessarily furnishes the one and only sound answer for income tax purposes. If it did, the hands of the Internal Revenue Service would be effectively tied.

"Generally accepted accounting principles" mean just that, namely, that a given treatment of an item has been accorded some general acceptance. The general acceptance can come from a number of different sources, such as acceptance by state or federal regulatory agencies; but such acceptance does not mean that a given treatment of an item is the only treatment of that item having general acceptance, or even that the given treatment

is the most sound or accurate. Indeed, it is common knowledge that the same item will be treated differently by different corporations, and yet reputable accounting firms are able to certify as to the financial position of both corporations with respect to their respective balance sheets and statements of operations.

This principle is explained by Paul Grady in the "Inventory of Generally Accepted Accounting Principles For Business Enterprises", an accounting research study published in 1965 by the American Institute of Certified Public Accountants, Inc., which discusses the matter at pages 50-53, and states that an accounting practice will be "generally accepted" if it has the support of regulatory commissions.

Thus, the fact that capitalization of the secondary reserve premium was decreed by regulations of the California Savings and Loan Commissioner and by the Federal Home Loan Bank Board (petition, page 7) was sufficient to enable Peat, Marwick & Mitchell to certify that such treatment was in accord with "generally accepted accounting principles."

But such treatment was severely criticized by the two expert witnesses who testified in the present case, both eminently qualified, namely, Robert T. Sprouse, Professor of Accounting at the Graduate School of Business at Stanford University [Rep. Tr. pp. 43-61], and Wayne S. Boutell, Associate Dean of the School of Business Administration at the University of California at Berkeley [Rep. Tr. pp. 67-79].

The capitalization of such payments has recently been condemned by two prominent accountants, Karl M. Skousen, Professor and Chairman of Accounting, Brigham Young University, and K. Fred Skousen, As-

sistant Professor of Accounting at the University of Minnesota, in an article entitled "Savings and Loan Secondary Reserve Payments—Assets or Expenses?" published in the August, 1970 issue of "C.P.A.", monthly journal of the New York State Society of Certified Public Accountants, which is reproduced in this brief as Appendix B, pages 2-21. The headnote of the article reads:

> "Accounting by Government fiat, with the aim of bolstering a financially concerned industry having a major public interest, usually results in 'bootstrap uplift' measures. The statutory dispensation for treating secondary reserve payments as assets, the authors demonstrate, materially distorts financial statements of savings and loan associations. * * *"

4. This Case Presents No Conflict Between Circuit Courts Regarding Compulsion to Pay.

As its third reason for granting the writ, the petitioner states (page 16) that the portion of the majority opinion below "emphasizing the element of economic compulsion conflicts in principle with the conclusion of the Court of Appeals for the Eighth Circuit in *M.F.A. Central Cooperative v. Bookwalter*, 70-1 USTC, par. 9484." The petitioner asserts that while this case and the cooperative cases arise in different contexts, the question, insofar as the significance of economic compulsion is concerned, is identical, and is one that warrants consideration by this Court.

We respectfully submit that the foregoing assertion has no relevance here.

Petitioner asserts (p. 16) that *M.F.A. Central Cooperative v. Bookwalter, supra,* is squarely in conflict

with *Penn Yan Agway Cooperative, Inc. v. United States* (Ct. Cl.) 417 F. 2d 1372. But there is no conflict between those two cases on the vital issue decided in the instant case: namely, whether a payment constitutes an ordinary and necessary business expense or a capital expenditure. The Court of Claims in the latter case held that the payment there was deductible as interest—a bonus for a loan, rather than as an ordinary and necessary business expense. As the Court stated in the *M.F.A. Central Cooperative* case:

> "* * * The Court of Claims * * * discusses quite extensively the statutory background and purpose and considers the deductibility of the required amount paid for Class C stock purchases as a business expense *but it does not base its decision on the ground that the stock purchase price is a business expense.* * * *" (Emphasis added.)

The Court then concluded that the taxpayer "has not met the burden of establishing that the expenditure here involved is an ordinary expense."

Hence, we respectfully submit that there is no conflict between the two cases on the question of deductibility of business expenses.

But of even greater significance here is that the taxpayer in the present case has not contended, and the Court of Appeals for the Ninth Circuit did not hold, that an otherwise capital expenditure is converted into an expense item because the payment was made under legal or economic compulsion. Compulsion, whether legal or economic, should have no bearing upon the question whether a payment is an expense or a capital expenditure. That basic question should always be governed by the rights acquired as a result

of the payment, whether made voluntarily or under compulsion.

In the present case the taxpayer has contended that the rights, if any, it acquired by the payment in question were not sufficient to constitute a capital asset and hence the payment was not a capital expenditure. The Court of Appeals for the Ninth Circuit agreed with this contention (see its opinion in Appendix B of the petition, pp. 66-70). As heretofore stated, two District Courts have also agreed with this contention.

The question then becomes whether the payment, although not a capital expenditure, is an "ordinary and necessary business expense", so as to be deductible under section 162(a) of the Internal Revenue Code (Petition, Appendix E, p. 77).

It was at this point that the Court of Appeals for the Ninth Circuit referred to economic compulsion, in saying that a payment which must be made to stay in business fulfills "our conception of an 'ordinary' business expense." (Petition, Appendix B, p. 71).

We submit, therefore, that there is no merit in petitioner's attempt to display a conflict between the circuit courts on this point in the present case.

Conclusion.

The petition alleges (p. 11) that resolution of the question involved here "can be provided only through review by this Court at this time."

The taxpayer disagrees.

If resolution of the issue had been so important a federal question it is difficult to understand the Government's failure to appeal the adverse decision on June 17, 1968 in *First Federal Savings and Loan As-*

sociation of St. Joseph v. United States (D.C., W.D. Mo.) 288 F. Supp. 477.

But even more important is the Government's pending appeal to the Fifth Circuit of the adverse decision in *Washington Federal Savings & Loan Association of Miami Beach v. United States* (S.D. Fla.) 304 F. Supp. 1072. If the Government should prevail in that case there would then be a clear conflict between Circuit Courts, warranting resolution by this Court. But if the Fifth Circuit reaches the same conclusion as did the Ninth Circuit and the two District Courts, there would be no conflict; and it is to be hoped that the Internal Revenue Service would remove further difficulty by a sensible administrative promulgation. This case is no different than the many instances where the Commissioner, to serve his own purposes, refuses to follow circuit court decisions.

The petition has not established the importance usually deemed necessary for review of this case by this Court.

The petition for a writ of certiorari should be denied.

September 11, 1970.

Respectfully submitted,

A. CALDER MACKAY,
ADAM Y. BENNION,
Attorneys for Respondent.

APPENDIX A.

Section 563.16-2 of the FSLIC Rules and Regulations For Insurance of Accounts, Chapter V(D), Title 12, Banks and Banking, Code of Federal Regulations:

"Except as provided in the next following sentence or by action of the Corporation pursuant to the last sentence of said subsection (e), no right, title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise. In the event that an insured institution (hereinafter in this sentence called the surviving institution), the merging institution's pro rata share of the Secondary Reserve shall automatically be transferred to the surviving institution, and in such event the amount of the increase in all accounts of the surviving institution's insured members as of the December 31 next following such merger shall, for premium prepayment purposes, be adjusted by the Corporation so that such increase shall not include the accounts of insured members of the merging institution as of the close of the immediately preceding December 31."

APPENDIX B.

Savings and Loan Secondary Reserve Payments—Assets or Expenses?

By Karl M. Skousen and K. Fred Skousen

Accounting by government fiat, with the aim of bolstering a financially concerned industry having a major public interest, usually results in "bootstrap uplift" measures. The statutory dispensation for treating secondary reserve payments as assets, the authors demonstrate, materially distorts financial statements of savings and loan associations. In conclusion they set forth proposed steps that may make the statutory "bootstrap" unnecessary.

The question at issue here is whether or not Secondary Reserve (SR) payments (mandatory "prepayments," supplementing yet distinguished from regular insurance premium payments), now required of savings and loan association by the Federal Savings and Loan Insurance Corporation (FSLIC), should be recorded and classified for financial reporting purposes as assets or as expenses of operation.[1]

Current accounting practice records these payments as assets. To the extent that these payments are so treated, when asset characteristics are lacking and expense characteristics prevail, published financial statements of savings and loan associations are unrealistic and do not "present fairly the financial position and results of operations." Such a possibility, it seems to the writers, merits serious consideration by independent public accountants in the performance of their attest function.

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[1]Other questions raised by the applicable law and subsequent regulations, such as the deductibility of these payments for tax purposes, are outside the scope of this paper.

In determining how SR payments should be treated for accounting purposes, two primary questions (and their sub-issues) need to be considered. First, and of primary importance, do these so-called "prepayments" have the characteristics of asset? Second, if the "prepayments" do qualify as assets, what measurement problems exist? Obviously, if the payments do not qualify as assets, rather they qualify as expenses, they should not be capitalized. In order to view these questions in proper perspective, it is necessary to review the background of the problem.

BACKGROUND OF THE PROBLEM

FSLIC was created by Title IV of the National Housing Act of 1934 for the purpose of providing stability and restoring public confidence in the savings and loan industry. It is an instrumentality of the federal government, established by Congress to provide a minimum level of security for depositors' (shareholders') savings accounts at federally insured savings and loan associations.

The initial plan insured accounts up to $5,000 at an annual cost of ¼ of 1% of insured savings accounts. Later the premium cost was reduced to ⅛ of 1%. and in 1946 attempts were made to further reduce the premium to 1/12 of 1%. This latter attempt was unsuccessful, primarily because of insufficiency of FSLIC reserves. The original statute called for annual premiums until such time as FSLIC reserves reached 5% of the total amount of all accounts of insured members. In 1946 the reserves were well below 5%; actually, they were less than 2%.

In 1950 legislation was passed which, among other things, reduced the premium to 1/12 of 1% and increased insurance coverage to $10,000. However, during the 1950's insured savings increased much more rapidly than did FSLIC reserves, resulting in a steady decline in its reserve ratio. (In 1959 it was only 0.661%).[2] This brought pressure to increase the premium back to ⅛ of 1% and led directly to an alternative plan proposed by the United States Savings and Loan League.

The Prepayment Expediency. The alternative proposal provided for an additional premium, called a "prepayment," by each member association into a "Secondary Reserve" of the FSLIC. The impact was cushioned by the provision that the "prepayments" were to be treated by the association as assets. The plan further provided that the FSLIC credit each member association's SR account with a "return" (interest) on cumulative payments.[3] However, this return, although considered operating income to each association, was not to be paid in cash. In fact, it could not be withdrawn in the regular course of business, nor could it be applied directly to Primary or Secondary Reserve payments.

The effect of the proposed plan on association financial reports obviously is that whereas as ordinary increase in premium costs would have decreased re-

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[2]Report of a subcommittee appointed to inquire into the nature of payments into the Secondary Reserves of the FSLIC, Committee on Savings and Loan, California Society of Certified Public Accountants, August, 1968, p. 4.

[3]Such return was to be based on the average annual rate received by the FSLIC on its government portfolio.

ported net income, capitalizing them would improve reported profits and financial position.

Secondary Reserve Impact on Financial Statement Reporting*

S & L Assn.	% of Total SR to Total Assets	Current Year SR Increase $	Current Year SR Increase % of Net Income	Earnings Per Share $‡	Earnings Per Share $—Less Year's SR Increase	Increase in Earnings Per Share by Capitalization of SR $	Increase in Earnings Per Share by Capitalization of SR %
A	1.05%	$ 591,896	15%	$2.08	$1.76	$.32	18%
B	1.05	4,025,328	31	1.23	.85	.38	45
C	.84	148,639	20	.70	.56	.14	25
D	1.36	341,769	19	1.47	1.19	.28	25
E	.80	126,648	9	1.63	1.48	.15	10
F	1.29	629,501	14	(1.60)†	(1.83)	(.23)	(13)†
G	.99	32,222	20	.36	.29	.07	24
H	1.05	288,463	18	1.59	1.31	.28	21
I	.92	49,196	45	.68	.37	.31	84
J	.96	34,150	16	.10	.08	.02	25
K	.48	88,245	9	1.47	1.33	.14	11
L	1.20	210,583	12	.75	.66	.09	14

*The data presented in this table were obtained from 12 savings and loan association's 1967 and 1968 annual reports to shareholders, selected at random from among the 44 associations which file with the Securities and Exchange Commission.

†Decrease in loss per share.

‡Before extraordinary items.

The accompanying table shows the effect on the balance sheet and the income statement resulting from the capitalization of SR payments. The amount accumulated to date in the SR account as a percent of total assets is insignificant, usually about one percent. But when compared to net income before extraordinary items the current year increase in the SR is material, typically between 10 and 20 percent.

The effect on the income statement is much more pronounced than on the balance sheet. By capitalizing

SR payments instead of charging them as operating expenses, reported earnings per share figures are significantly improved, usually more than 15 percent. (See Table.)

Changes in SR Payments. Legislation enacted in September, 1961, Public Law 87-210, followed closely the general provisions of the United States Savings and Loan League plan just summarized. More specifically, it provided that member associations of the FSLIC continue to pay into a general reserve, called the Primary Reserve (PR), an annual premium equal to 1/12 of 1% of the total amount of all savings accounts and creditor obligations outstanding; pay an additional yearly premium into an SR equal to 2% of the net increase in all accounts of the association during the preceding calendar year, less an amount equal to requirements for purchase of stock of a Federal Home Loan Bank;[4] and receive credit on the books of the FSLIC for interest on cumulative SR payments.

Public Law 91-151, enacted in December, 1969, effective January 1, 1970: (1) reduced payments to the Primary and Secondary reserves by eliminating "creditor obligations outstanding" from consideration in premium or reserve calculations; (2) gave authority to regulate rates of interest or dividends on time and savings deposits; increased account protection to insured savers from $15,000 to $20,000; and (4) gave authority the Treasury Secretary to lend an additional $3 billion to the FHL Banks.

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[4]With the enactment of this legislation, the requirement that insured associations hold Federal Home Loan Bank stock equal to 2.0% of individual aggregate unpaid loan principal was reduced to 1.0%.

Payments into the SR were described as "in the nature of a prepayment with respect to future premiums" and become a pool of wealth to be used if the Primary Reserve and earnings are inadequate for meeting obligations of the FSLIC. These obligations may be classified as (1) administration and liquidation expenses, (2) insurance losses, and (3) provisions to the SR accounts of member associations as interest or earnings on accumulated SR payments.

The law further provides that the SR payments are not exchangeable or transferable except by consent of the FSLIC in stipulated types of business combinations. They are not refundable in cash except upon membership termination with the FSLIC, upon liquidation of the enterprise, or at such time as the PR, by itself, accumulates to 2% of the total amount of savings.

Condition For Suspension of Payments. Another provision in the law is that when the combined total of Primary and Secondary Reserves for all member institutions equals or exceeds 2% of total insured savings, such payments will be temporarily suspended until such time as the combined total drops to 1.75%. During this period the annual insurance premium (PR) will be paid by credit from the individual association's pro rata share of the SR to the extent available, rather than by cash. When the combined total drops to 1.75%, payments will be resumed until the combined total once again reaches the 2% level. Fluctuations between 2% and 1.75% will continue until, as mentioned above, the Primary Reserve alone accumulates to 2% of total insured savings. (Original estimations were that this would occur in 1995). At such time, a pro rata cash

refund of the SR will be made to participating associations and SR payments will no longer be required, even if the PR subsequently drops below the 2% level.

THE ASSET TEST

With this background in mind let us proceed to determine whether the prepayments have any asset characteristics. Authorities tend to agree that for an expenditure to be properly classified and recorded as an asset requires (1) an existence of future benefits or service potentials, and (2) that these future benefits accrue to a specific entity. (See references which follow.)

Requiring the existence of future benefits or service potentials is another way of saying that assets are things of value; that they have future usefulness to an entity.[5] When expected future benefits no longer exist or when usefulness to an enterprise is unlikely, an item should be excluded from the assets of that enterprise and should be treated as a current charge against in-

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[5]J. C. Bonbright states that ". . . things are deemed to have value for their supposed capacity to perform services for those persons who can exploit them by exercising the powers of ownership." He further points out that ". . . the value of property is nothing but the value of an opportunity to derive future profits or other services . . ." See *The Valuation of Property*, Vol. I, (McGraw-Hill, 1937), pp. 14, 20 respectively.

Hendriksen indicates that all assets obtain their value to the firm because of their expected contribution to the stream of future earnings and cash flows. Eldon S. Hendriksen, *Accounting Theory*, (Richard D. Irwin, 1965), p. 348.

The American Accounting Association's 1957 Revision states that "assets are economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service —potentials available for or beneficial to expected operations." *Accounting and Reporting Standards for Corporate Financial Statements*, p. 3.

come, regardless of whether this charge is classified as an expense, a loss, or as part of cost of goods sold.[6]

An additional condition to the existence of future benefits or service potentials is that an entity own or have the rights of ownership to the future benefits or service potentials. Unless an enterprise expects to have these potential services available for its use, i.e., is able to exercise ultimate and intermediate control over these potential services, it will derive little, if any, benefit from them and should not include them as part of its assets.[7]

An extension of the second asset characteristic is that there be a legally enforceable claim insuring usability rights.

Services that can be withdrawn at will by some other firm or individual or by the government without compensation should not be included as assets. This does not mean, of course, that the firm must have a formal legal title or even a formal contract. In most cases, the accountant must rely upon the apparent intent of those who may have an interest in the asset rather than on the strict legality of the right.[8]

Thus, assets are viewed here as aggregates of service potential; they are rights to future economic benefits accruing to and controllable by a particular entity.

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[6]"When the service potential of a given asset is no longer available to the enterprise . . . (the) cost of the asset . . . should be eliminated from the accounts . . ." *Ibid.*, p. 5.

[7]Eric Kohler points out that "perhaps the most important characteristic of an asset recognized by the accountant is its usefulness to the owner. An object or right is considered useful if it is the source of, or can be used to secure, future services economically advantageous, not to *any* person, but to its present owner." *A Dictionary for Accountants*, 3rd Edition, (Prentice-Hall, Inc., 1963), p. 42.

[8]Hendricksen, *op. cit.*, pp. 194-195.

When items no longer have any discernible benefit for a particular entity in future periods, they are not assets but are expenses to be charged against current revenues.

Given the above characteristics, do SR payments qualify as assets? Are there future benefits to be derived from these payments? Do such benefits accrue to a specific entity, an individual savings and loan association in this case? Is that entity able to control and use the benefits as needed, or are such benefits subject to withdrawal at will by some other firm or by the government?

Future Benefits from Secondary Reserve Payments? One might initially agree that payments into the Secondary Reserves of the FSLIC do, in a general sense, secure future benefits if they meet these conditions: (1) they can be used to pay future regular (PR) premiums, provided that the combined PR and SR balances are equal to or exceed 2% of total insured savings; (2) they will be fully refunded in the event of discontinuance of insurance, liquidation of the association, or at such time as the Primary Reserve, by itself, equals or exceeds 2% of total insured savings; and (3) they have some characteristics of an investment which earns a return on amounts paid in, although, in this case, the return is not available to the association for its use until some future, indeterminable date. Closer examination reveals, however, that these apparent asset characteristics are illusory and should not govern.

As to the *first condition*, note that SR payments can be used to pay regular premiums only if the Primary and Secondary Reserves combined equal the 2%

criterion. Based on a 1961 estimate of savings growth, this level of 2% of total insured savings was originally projected to be reached in 1970. Later it was estimated that the 2% level would likely occur as late as 1976, based on revised projects prepared by the FSLIC.[9]

Enactment of Public Law 91-151 reduced reserve requirements arbitrarily. This action, in the face of depressed savings and loan association operations during the late 1960's, had the effect of increasing the relative level of reserves, and produced a 2% level by 1970 as originally predicted. Therefore, letters have been mailed by the Federal Home Loan Bank Board informing insured institutions that beginning January 1, 1970, SR payments will be suspended until the aggregate reserves of the FSLIC fall below the 1.75%, and that each institution's pro rata share of the SR, to the extent available, will be used to pay the "annual insurance premium" (PR).

Thus benefits are now being received from prior SR payments made by insured institutions. However, it is interesting to note the combination of circumstances that brought this about. First, the tight money market has cut sharply into funds which individuals are putting into savings and loan associations. This has had the opposite effect from that of the 1950's when insured savings increased rapidly, causing a steady decline in the FSLIC ratio.[10] Second, the law was amended,

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[9]Report of California CPA Committee, *op. cit.*, pp. 19-20.

[10]In 1946, associations held $25 in savings for each $100 in commercial banks' savings and other time deposits. By 1961 the ratio was $85 to $100. Since 1961 there has been a decline to $69 for each $100 in banks. *U. S. News & World Report*, May 11, 1970, p. 95.

reducing the base upon which reserve payments are computed. The change in the law was made because of "potential serious problems" in the savings and loan industry.[11] Thus, at a time when money is tight, business is declining, and the entire industry is faced with serious problems,[12] account protection is increased and reserve requirements are decreased. Certainly, association cash positions will be improved and those savers with larger savings accounts will be better protected.

However, the question still remains: Is not the SR payment an expense of operation, an insurance premium, which has been paid into an insuring organization to bolster public confidence and to provide saving account protection? The mere fact that the FSLIC is a government agency and can be given powers, concessions and considerations not ordinarily available to private institutions does not change the character of an expenditure from that of an expense to that of an asset. Moreover, if the Agency decides in the future to call for SR payments the problem of capitalization or charge-off will reappear.

Realistically, at least so it seems to the writers, the situation is such that reserves should now be increased,

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[11]In November, 1969, officials ranked 18 associations with total assets of $2 billion as "probable candidates for assistance." As of April, 1970, about 15 associations with assets approaching a total of $1 billion are on the Government's list of shaky financial institutions. *The Wall Street Journal,* April 14, 1970.

[12]A prominent savings and loan executive from the Midwest has stated, "we can't go on for long this way. Unless the industry undergoes fundamental changes, it may, indeed, face extinction." The president of the National League of Insured Savings Associations, Paul Westerfield, Chairman of the Home Federal Savings and Loan Association, Cincinnati, also said: "We're probably in a battle for survival. Some will endure and some will not." *U. S. News & World Report,* May 11, 1970, p. 96.

rather than decreased as at present. The original statute called for annual premiums until such time as FSLIC reserves reached 5% of the total amount of all accounts of insured members. A 5% level does not appear excessive when viewed in terms of current economic conditions facing the savings and loan industry. Factors which support this view are: (1) changes in the rate of growth of savings, (2) changes in intermediation or disintermediation and (3) the present attitude of savers who currently are more inclined to go directly into the market.

The *second condition* whereby future benefits might be received is possibility of recovery of the SRs in the event of discontinuance of insurance, liquidation of the association, or at such time as the PR, by itself, equals or exceeds 2% of total insured savings.

Discontinuance of insurance without discontinuing business is virtually impossible. Federal associations cannot, and competition will not permit state associations to do so. If an association were forced to liquidate, asset realizations would likely be reduced significantly and the amount and timing of any SR repayments would be uncertain and not easily predictable.

SR payments are also refundable when the PR alone accumulates to 2% of total insured savings. When the SR program was created in 1961, the PR was approximately 0.66% of insured savings. At December 31, 1967 it was about 0.73%.[13] Growth appears to be

[13]Alan McNaughton, "An Analysis of the Accounting Treatment of Prepayments to the Secondary Reserve of the Federal Savings and Loan Insurance Corporation for Financial Statement Purposes of Insured Savings and Loan Associations," Unpublished manuscript, p. IV-7.

slow. One writer has stated, "assuming a growth in savings accounts of 10 percent annually, the PR balance will reach only approximately 1 percent after 20 years."[14] Of course, if there is no growth in savings and if associations remain solvent and in business, the period might be shortened, a highly unlikely situation. Original calculations indicated an accumulation to 2% by 1995. They were based in part on a no-loss assumption. Losses have been sustained, and although they only represent 80 cases and total to $125.9 million since the FSLIC was created in 1934, it does not follow that losses will continue to be insignificant in total.[15] Losses have increased significantly during the last ten years.[16]

As to the *third condition, investment characteristics of SR payments,* by law the FSLIC is required to credit each member association's SR account with a "return" on such accumulated payments. However, the

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[14]"Deductibility for Income Tax Purposes of Payment to the Secondary Reserve of the Federal Savings and Loan Insurance Corporation," *The Ohio Savings and Loan Record,* (January, 1967, p. 10.)

[15]*The Wall Street Journal,* April 14, 1970.

[16]Actions which may be taken by the FSLIC include: (1) standby agreements to make contributions in the future, e.g., where merger of a weak institution with a stronger one is recommended, (2) purchase of assets, (3) loans, (4) combinations of these methods, and (5) receivership (insurance payment). During the 34 first years of operation of the FSLIC only 12 insurance payments cases have taken place. However, of these 12, one was in 1965, two in 1966, and two in 1968. The cases in 1968 resulted in payments to insured savers of two Chicago savings and loan associations of $119.7 million with pending and unclaimed accounts at year-end of $0.9 million. Another Chicago association with savings account balances of $22.8 million, in a default prevention action, was merged into a fourth Chicago association. A number of merger default prevention actions has taken place within the last few years. (See *36th Annual Report-1968,* Federal Home Loan Bank Board), pp. 54-62.

crediting of this return may be misleading. From the standpoint of realization, revenues do not exist. Realization usually requires a conversion through legal sale or similar process, and that the conversion be validated through the acquisition of liquid assets.[17] These two tests are not met with a mere accounting entry, the recording of a "return" on an association's books. There are no liquid assets available to the association at that point in time; there is nothing the association can use, either to generate revenues or as liquid funds for operating expenditures or for payment of liabilities, except in one case of applying them toward payment of the annual insurance premium when conditions are met which permit this. The only way the returns could be converted into cash for immediate use is by dissolution of the member association or from its withdrawal from the FSLIC, certainly not a normal activity nor in keeping with the going concern concept generally assumed in accounting.

Another basic difference between SR payments to the FSLIC and investments is that investments are usually controllable by the investor. If the investment is unsatisfactory, it can be withdrawn and placed elsewhere. This cannot be done with SR payments. As stated previously, it is only at that point in time when PRs alone equal 2% of insured savings that SRs will be refunded to member associations. Until then they are at all times under the control of the FSLIC.

Even by defining an investment very broadly, SR payments would be considered an involuntary invest-

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[17]W. A. Paton and A. C. Littleton, *An Introduction to Corporate Accounting Standards,* (American Accounting Association Monograph, November 3, 1962), p. 49.

ment, one which provides no expendable dividend and one over which there is little, if any, control. Thus, considering the above factors, it appears that the FSLIC, not its member associations, exercises control over these payments.

PROPER MATCHING OF REVENUES AND RELATED EXPENSES PRECLUDES CAPITALIZATION.

There is still another factor which the authors feel is pertinent. Classifying SR payments as investment type assets does not provide an appropriate matching of revenue and expense. Generally, the accounting concept of matching requires that costs or expenses be charged against revenues generated by the incurrence of such costs or expenses. That is, that both revenues and their related expenses be reported in the same accounting period in determining income. If SRs are shown as assets and deferred to some future distant accounting period this will not be done. The benefit accrues to the association at the time payment is made to the FSLIC. The association is buying insurance protection for its savers, and when saver protection is assured, public confidence is bolstered. As a result, additional savings normally flow to the savings and loan association. To say that this is not the benefit for which the association pays its insurance premiums, call them reserves or whatever, is a misstatement of fact. The FSLIC is an instrumentality of the federal government created by Congress to insure savings accounts at savings and loan institutions. When FSLIC insurance protection is in force, savers place their funds with a savings and loan association with confidence. Withdraw that protection and the funds will quickly flow

elsewhere. Thus, there is a direct relationship between revenues and these expenditures (expenses) currently, not at some as yet indeterminate future date.

In summary, SR payments made to the FSLIC contribute to saver confidence and the increased cash flows currently. They are not likely to contribute to a stream of future earnings or to cash flows under normal operating conditions. At best they can only reduce far-in-the-future expenditures for savers' account insurance protection.

FEDERAL COURTS AFFIRM EXPENSE CONCEPT

In the Memorandum Opinion of the recent court ruling, Chief Judge Charles B. Fulton stated:

> It is the view of this Court that the only significant difference between the regular premiums (Primary Reserve) and the additional premiums (Secondary Reserve) is the fact that there exists a contingent possibility that the additional premiums may some day be recovered. For reasons which will appear below, this fact does not render the additional premiums non-deductible (as ordinary and necessary business expense for tax purposes). In all other respects, the regular and additional premiums are substantially identical and, in fact, the additional premiums are for all practical purposes nothing more than an increase in the amount of the regular premiums.
>
> Plaintiff's purpose in paying the additional premiums is the same as its purpose in paying the regular premiums. It is required by law to insure its accounts and it must pay both premiums

> in order to maintain the insured status of its accounts. If it fails or refuses to make either the additional or regular premium payments, the FSLIC would terminate its insured status, acting under the provisions of its Regulations, 12 CFR Sec. 565.2. There is no distinction in those regulations between failure to make one payment as opposed to the other. Therefore, with respect to both regular and additional premiums, there exists precisely the same compulsion to pay, the same purpose in paying, and the same consequence of failure to pay. Likewise, in the hands of the FSLIC, the regular premiums (after deducting the portion used for operating expenses) and the additional premiums serve identical functions. They are held as reserves against losses. While two separate reserves are established—Primary Reserve and Secondary Reserve—there is no difference in function between the two reserves, both of which are established for the single purpose of meeting future losses.[18]

Similarly, a decision of the Tax Court of the United States in the Lincoln Savings and Loan Association vs. Commissioner of Internal Revenue was reversed. In essence the court's decision was that SR payments made to the FSLIC by an insured institution are ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.[19]

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[18]Memorandum Opinion of Chief Judge Charles B. Fulton, United States District Court, Southern District of Florida, in the case of Washington Federal Savings and Loan Association of Miami Beach, Plaintiff, vs. United States of America, Defendant. No. 67-266-civ-CF, entered September 26, 1969, pp. 8-9 and p. 10.

[19]In The United States Court of Appeals for the Ninth Circuit.

SUMMARY AND CONCLUSION

In the above discussion, an attempt has been made to point out certain accounting issues relating to the treatment, for accounting and reporting purposes, of Secondary Reserve payments to the FSLIC. On the basis that asset characteristics are lacking and because of the measurement problems involved, the propriety of current practice, which classifies and records SR payments as assets, has been questioned. It follows that: (1) if no benefits from SR payments are anticipated, or (2) if uncertainties are such that benefits may not accrue, or (3) if benefits likely to accrue are so far removed from the present as to make their present worth negligible or nonexistent, it is questionable practice to report as assets those amounts remitted to the FSLIC by savings and loan associations as SR payments.

It would seem that, since projected PR and SR accumulations and balances are based on assumed growth rates, inflationary trends, loss estimates, and many other factors, and since uncertainties as to these and the other factors do exist, SRs, if classified as any type of asset at all, should be classified as contingent assets. As such they would be more realistically reported by footnotes.

Even if it were conceded that SRs have some elements characteristic of assets, reporting such elements at amounts substantially in excess of present values (even assuming minimal rates of interest) may be misleading.

Transfer of control, use, and for all intents and purposes, legal title, seems to indicate that the transfer of funds from a savings and loan association to the

FSLIC does not result in mere transfer of one type of asset for another by the association. Rather, it would seem that it is an expenditure of an asset for services, services which are directly related to providing insurance on depositor's accounts and of providing stability and public confidence in the savings and loan industry.

Essentially, then, the analysis presented in this paper of the basic characteristics of assets, when compared with the intent and nature of SR payments, leads to the conclusion that, for accounting and reporting purposes, these payments should be treated as expenses, not assets. This conclusion has been affirmed in recent Federal court decisions. If future benefits exist, they are so uncertain as to amount and timing as to preclude realistic classification as assets. Capitalizing these payments results in a material overstatement of earnings and earnings per share in the income statement and an overstatement of asset and retained earnings accounts in the balance sheet. It does not result in realistic and fair presentation to financial statement readers.

PROPOSED SOLUTION

The FSLIC is a creation of Congress, created in 1934 by Title IV of the National Housing Act. Since then, legislative amendments have modified the original Act. If the recommendations of this paper were followed, Congress, through legislative action, would once again be required to modify the Act. Included without elaboration as to detail, the plan presented below, if enacted by Congress, would permit realistic and fair presentation of financial data to savings and loan association financial statement readers.

Alternatives which might be followed in disposing of SR accumulations now shown on member associa-

tions' books run from the extremes of an immediate write-off of accumulated amounts to a permanent capitalization in the form of a "stock" investment. Among these alternatives, the writers view the following plan as one which merits consideration.

1. Discontinuance of SR payments; adjustment of the Primary Reserve premium rate so that sufficient funds will be available to meet any FSLIC losses and normal operating expenses.

2. Use of part of the SR accumulated balances to reduce current payments to the PR by member associations. (This would decrease current cash outflow requirements of member associations and would be particularly helpful with the present tight money situation.)

3. Write-off of the remaining balances in the SR accounts against non-operating income over the next five to ten years. (So as to not make the charge too extreme, perhaps settle on a 10 percent write-off per year.)

4. Proforma disclosure of income and earnings per share figures which would have resulted if SR payments had been charged to expense. (This would be a practical modification of requiring retroactive adjustments in the historical financial statements.)

In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 544

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LINCOLN SAVINGS AND LOAN ASSOCIATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE COMMISSIONER

The purpose of this reply is to point out the critical errors that underlie respondent's contention that the issue here lacks administrative or fiscal significance.

1. Respondent rests its entire argument with regard to the administrative significance of this case on Section 1312(7)(C)(iii). In reliance on that provision, respondent contends (Br. 7–10) that it would be unnecessary for savings and loan associations which have claimed current deductions for Section 404(d) payments to file protective claims for refund for later years in order to be assured of obtaining at least one deduction. This contention (summarized in point 2, Br. 9–10) is incorrect. Section 1312(7) applies only if, in the language of the pertinent regulations, "the determination establishes the basis of property" and

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an error occurred "in respect of a *prior transaction* upon which such basis depends, or in respect of a *prior transaction* which was erroneously treated as affecting such basis * * *." (Emphasis supplied.) Treasury Regulations on Income Tax (1954) Code), Section 1.1312–7(a). The basis "determination" involved in this and the 2,487 similar cases now pending is for taxable years in the 1960's. With regard to this "determination," there is no "prior transaction" to which Section 1312(7) could apply.[1] Under the government's theory of the case, Section 404(d) payments could be deducted only in *subsequent* taxable years (beginning in 1970). Thus, respondent and other similarly situated associations could not rely on Section 1312(7) to lift the bar of the statute of limitations for the later years and would be required to file protective claims for those years, with the resulting serious administrative difficulties described in our petition (Pet. 9–11).[2]

[1] That Section 1312(7) applies only to a basis error in a taxable year preceding the year of the "determination" is made clear not only by the regulations discussed above but by the unequivocal language of the statute itself. Section 1312 (7)(C) refers to the "PRIOR ERRONEOUS TREATMENT" and serves to lift the bar of the statute of limitations for the prior year in which the basis error was made. It does not reopen a subsequent taxable year otherwise closed by the statute where, as in this case, the basis error occurs in the earlier year in which the determination is made. The portion of the Senate Finance Committee report quoted by respondent (Br. 8–9) assumes that the taxpayer filed a timely claim for the later year.

[2] In points 1, 3 and 4 of its brief (Br. 9–10), respondent refers to three other possible situations that may arise in connection with the Section 404(d) payments. These are straw issues as to which no claim was made in the petition, and

These difficulties will continue even if the Fifth Circuit affirms the district court's decision for the taxpayer in *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, 304 F. Supp. 1072 (S.D. Fla). Respondent states (Br. 19) that, in this event, "it is to be hoped that the Internal Revenue Service would remove further difficulty by a sensible administrative promulgation." By this, respondent presumably means that the Service should thereafter subscribe to the rule adopted by the Ninth Circuit below. But, as we show in our petition (Pet. 10–11), no "sensible administrative promulgation" can solve the problem, because, even if the Service decides to follow the Ninth Circuit's rule, there can be no assurance that all savings and loan associations will do so. The uncertainty engendered by the possibility of additional litigation—regardless of what position the Service takes—and the consequent need for filing protective claims will continue until this Court provides a controlling solution.

2. In its opening argument (Br. 4–7), respondent points out that, under the government's theory, deductions will be allowed in 1970 and immediately succeeding years. From this, respondent concludes that the case lacks fiscal significance because the government's revenue loss will be substantial in the early 1970's irrespective of the ultimate resolution of the Section 404(d) payment problem.

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which have no bearing on the administrative problems discussed therein. The critical point is that respondent has erred in asserting that it and other taxpayers similarly situated could avoid filing protective claims in reliance on Section 1312(7).

Respondent is saying no more than that the question here is one of the proper timing of deductions—a fact noted in our petition (Pet. 8)—rather than one of whether a deduction should be allowed at all. In the present context, however, the timing problem alone involves substantial amounts of revenue.[3] That problem cannot be dismissed on the ground, suggested by respondent (Br. 7), that the government might have had to borrow at higher than the statutory six percent rate in the open market, in order to finance operations. In appraising the fiscal significance of the timing aspect, the open market rate—whether higher or lower than six percent—is irrelevant. What is relevant is whether the government was entitled to the funds in the first instance at no cost at all, and, for this purpose, the full amount of interest in dispute is to be taken into account.

Respectfully submitted.

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SEPTEMBER 1970.

[3] The 22 million dollars of interest on presently pending claims is only a fraction of what ultimately will be involved. As explained in the petition (pp. 8–9), additional interest liability will arise with respect to claims not yet filed for prior years and with respect to future years.

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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 544

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LINCOLN SAVINGS AND LOAN ASSOCIATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 39–74) [1] are reported at 51 T.C. 82. The opinion of the court of appeals (R. 76–83) is reported at 422 F. 2d 90.

JURISDICTION

The judgment of the court of appeals (R. 84) was entered on February 3, 1970. The Commissioner's timely filed petition for rehearing *en banc* was denied on March 18, 1970 (R. 85). By order dated June 12,

[1] "R." references are to the separately bound record appendix.

1970, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including August 15, 1970. The petition was filed on August 14, 1970, and certiorari was granted on November 9, 1970 (R. 85). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a payment by a savings and loan association to the Federal Savings and Loan Insurance Corporation pursuant to Section 404(d) of the National Housing Act is a nondeductible capital outlay, or is deductible as an ordinary and necessary business expense under Section 162(a) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in Appendix A, *infra*, pp. 41–43. The pertinent provisions of the Federal Home Loan Bank Act and the National Housing Act, before and after their amendment in 1961, are set forth in Appendices B and C, *infra*, pp. 45–56.

STATEMENT

Respondent, a state-chartered (California) savings and loan association, is a member of the Federal Home Loan Bank of San Francisco,[2] and insures its depositors' accounts through the Federal Savings

[2] That bank and other federal home loan banks were established under authority of the Federal Home Loan Bank Act, c. 522, 47 Stat. 727 (12 U.S.C. 1421, *et seq.*).

and Loan Insurance Corporation ("FSLIC").[3] At all relevant times, respondent has been a subsidiary of First Lincoln Financial Corporation, a corporation whose stock is publicly held and traded over the counter. It filed its federal income tax return for 1963, the taxable year here in question, using the cash receipts and disbursements method of accounting.

To maintain depositors' insurance in force, respondent is required to pay to FSLIC regular annual insurance premiums. See Section 404(b) of the National Housing Act (Appendix C, *infra*, p. 51). Such premiums are deductible as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code (Appendix A, *infra*, p. 41). In addition to the "Section 404(b)" payments, respondent is required in certain years to make other payments to FSLIC, described in Section 404(d) of the National Housing Act (Appendix C, *infra*, pp. 52–53) as being "in the nature of * * * prepayment[s] with respect to future premiums." It is the tax character of the "Section 404(d)" payments—whether they are capital expenditures or deductible business expenses—that is here in dispute.

[3] FSLIC, which was created under Title IV of the National Housing Act, c. 847, 48 Stat. 1246 (12 U.S.C. 1724, *et seq.*), operates under the direction of the Federal Home Loan Bank Board. All federal savings and loan associations are required by law to insure their accounts with FSLIC; qualified state-chartered savings and loan associations are permitted to do so. Section 403 of the National Housing Act (12 U.S.C. 1726). Respondent has been a member of FSLIC since 1938 (R. 15, 42).

Section 404(b) payments received by FSLIC are part of its gross income, are available to meet its current expenses and losses, and, to the extent not so used, are transferred to FSLIC's "Primary Reserve." The Primary Reserve, established pursuant to Section 404(a) of the National Housing Act (Appendix C, *infra,* p. 51), is credited annually with FSLIC's net income and thus represents its retained earnings. As such, it is available to meet any losses suffered by FSLIC in future years.

Unlike Section 404(b) payments, Section 404(d) payments are not considered part of FSLIC's regular income but are transferred directly to FSLIC's "Secondary Reserve," as required by Section 404(a). This Reserve is available to FSLIC only to meet its losses and only then to the extent that other available accounts are insufficient to meet such losses. See Section 404(e) of the National Housing Act (Appendix C, *infra,* p. 53). The financial statements of FSLIC reveal no year in which its net insurance losses exceeded even its investment income from the Primary Reserve (R. 20, 40, 59; Ex. 42, p. 17; Ex. 43, pp. 30–31; Ex. 48, p. 17; Ex. 49, p. 19).

An insured savings and loan institution has no interest in FSLIC's Primary Reserve. But it does have a beneficial ownership interest in the Secondary Reserve. That interest is reflected in each institution's separate account maintained by FSLIC (R. 20, 35-36, 52, 57). The amounts in the Secondary Reserve may be withdrawn and used to pay the institution's regular insurance premiums in future years after the total

of the Primary and Secondary Reserves reaches certain levels as explained below. The insured institution's separate account includes a pro rata share of the earnings allocated to the Secondary Reserve "at a rate equal to the average annual rate of return to the Corporation * * * on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States."[4] See Section 404(e).

Under Section 404(b), respondent is required to pay the regular annual premium at the rate of 1/12 of one percent of the total amount of its savings accounts and creditor obligations until such time as FSLIC's Primary Reserve equals two percent of total insured savings accounts and creditor obligations of all insured institutions. Thereafter, additional annual payments are to be made whenever the Primary Reserve falls below the two percent level.[5] Statements for

[4] Not only does FSLIC maintain a separate record of respondent's share of the Secondary Reserve, but it also forwards annual statements to respondent showing, among other things, its current share of the Secondary Reserve and the interest credited to its account during the preceding year (R. 20, 37–38, 52, 57–58). As of December 31, 1967, respondent's pro rata share of the Secondary Reserve amounted to $4,922,115.46 (R. 35, 38, 52). From 1962 through 1967, the rate of return on FSLIC's government securities ranged from 3.15 to 4.23 percent (R. 35–38, 52).

[5] Prior to 1962, annual premiums of 1/12 of one percent of savings accounts and creditor obligations were likewise required, but under the statute then applicable such payments were to be made until FSLIC's general reserve (now the Primary Reserve) equalled or exceeded five percent of insured accounts and creditor obligations of all insured institutions.

the Section 404(b) payments are rendered by FSLIC in the form of "Insurance Premium Notices" (R. 17, 27, 51, 54).

Under Section 404(d), an insured institution must make additional payments in an amount equal to two percent of any net increase in its insured accounts and creditor obligations during the preceding year,[6] reduced by its obligation, if any, as of the end of such year to purchase capital stock in its federal home loan bank. Pursuant to Section 6(c)(1) of the Federal Home Loan Bank Act (12 U.S.C. 1246) (Appendix C, *infra,* p. 49), a member institution in a federal home loan bank must own capital stock in that bank in an amount at least equal to one percent of the member's outstanding unpaid loan principal.[7] FSLIC invoices a Section 404(d) payment by sending a sepa-

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See Section 404(a) of the National Housing Act (Appendix B, *infra*, pp. 46–47). Congress amended Section 404 of Title IV of the National Housing Act (12 U.S.C. 1727) in 1961, effective January 1, 1962. Act of September 8, 1961, P.L. 87-210, 75 Stat. 482.

[6] Prior to the effective date of the amendment of the National Housing Act (see n. 5, *supra*), Congress did not require FSLIC to maintain a Secondary Reserve and there was no provision other than for regular insurance premiums.

[7] Before 1962, the requirement was two percent. In the same act in which Congress amended the National Housing Act (see n. 5, *supra*), it also amended the Federal Home Loan Bank Act, contemplating that the newly imposed Section 404(d) "prepayment requirement would be approximately offset" by the reduction in required outlays for federal home loan bank stock. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2. Respondent has always capitalized its payments for such stock (R. 62).

rate "Notice of Insurance Premium Prepayment" to each insured institution (R. 17, 28–29, 51–52, 54).

When at the close of any calendar year, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make Section 404(d) payments is suspended until such aggregate amount falls below 1¾ percent of all insured accounts and creditor obligations; the obligation is terminated when the amount in the Primary Reserve alone equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions.[8] In any year in which the obligation to make Section 404(d) payments is suspended, the pro rata share of each insured institution in the Secondary Reserve will be used, to the extent needed and available, to make Section 404(b) payments. Section 404(g) of the National Housing Act (Appendix C, *infra*, pp. 55–56).

According to FSLIC projections made in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured

[8] Section 404 of the National Housing Act was amended by P.L. 91-151, 83 Stat. 371, enacted on December 23, 1969, to provide that only insured accounts (and not creditor obligations) are to be taken into account in determining the required two percent levels in connection with both the suspension and termination of Section 404(d) payments. In the body of this brief we shall refer to Section 404 prior to this amendment unless otherwise noted.

institutions by 1970, and the Primary Reserve itself would reach the two percent level in 1995 (R. 49–51).[9]

Although an insured institution's "right, title or interest" in the Secondary Reserve is not generally transferable or assignable, FSLIC has authority to provide for the transfer of an institution's pro rata share "in cases of merger or consolidation, transfer of bulk assets * * * and similar transactions." Section 404(e).[10] Moreover, an insured institution is entitled to a cash refund of its pro rata share in the event that (1) its status as an insured institution is terminated, (2) a conservator, receiver, or other legal custodian is appointed for the purpose of liquidating the assets of the institution, (3) FSLIC determines that such institution has gone into liquidation, or (4)

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[9] The FSLIC estimates (R. 50) show that Section 404(d) payments would be required to be made from 1962 through 1970, and from 1976 through 1979, and that no such payments would be required from 1971 through 1975, and from 1980 through 1995. Because of the 1969 amendment (n. 8, *supra*), the combined Primary and Secondary Reserves reached the two percent suspension level in 1969, rather than in 1970 as originally projected. Beginning in 1970, the Secondary Reserves are being used to meet the insured institutions' obligations for Section 404(b) payments. Ward, *Taxation: Deductibility of Insurance Premiums by Federal Savings and Loan Associations*, 22 U. Fla. L. Rev. 674, 680. FSLIC has not yet prepared a new projection based on the 1969 amendment, but there is no reason to expect that the new estimates will vary significantly from the previous estimates.

[10] FSLIC has to this time provided by regulation for the automatic transfer of an institution's pro rata share in cases of merger and consolidation. 12 C.F.R. 563.16–2. Other transfers still require FSLIC approval.

the Primary Reserve alone reaches two percent of the total amount of all insured accounts and creditor obligations of all insured institutions. Section 404(f) and (g) of the National Housing Act (Appendix C, *infra*, pp. 54–56).

Pursuant to regulations issued by the California Savings and Loan Commissioner [11] and by the Federal Home Loan Bank Board,[12] respondent reported its interest in FSLIC's Secondary Reserve as an asset on its balance sheets and on its published financial statements, and treated the interest earned on its pro rata share of the Secondary Reserve as income (R. 53).[13] Respondent's parent, although not subject to federal or state accounting regulations, likewise

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[11] Under authority given by Section 8701 of the California Financial Code (30 West Anno. Calif. Code) to establish a uniform classification of accounts for savings and loan associations and to prescribe the manner in which such accounts are to be kept, the California Savings and Loan Commissioner requires that Section 404(d) payments be treated as an asset of a savings and loan association in an account entitled "Contributions to Secondary Reserve—FSLIC"; that the return credited to its pro rata share of the Secondary Reserve be treated as income; and that transfers from such pro rata share to discharge obligations to pay regular annual premiums be treated as expenses (R. 22–23, 31–32, 52–53).

[12] The instructions for the semiannual reports, which each member of the Federal Home Loan Bank System is required to file with the Federal Home Loan Bank Board, require that Section 404(d) payments be listed under "Schedule D, Other Assets" (R. 33–34, 53–54).

[13] Such interest, which is added to respondent's pro rata share of the Secondary Reserve, is not taxed in the year received but in the year in which it is utilized to pay respondent's regular annual insurance premium or paid to respondent in cash. Rev. Rul. 66–49, 1966–1 Cum. Bull. 36.

treated respondent's interest in the Secondary Reserve as an asset on its consolidated financial statements.[14] The firm of Peat, Marwick, Mitchell & Co., certified public accountants, stated in their audits of respondent's financial statements and those of its parent for the years 1962 through 1966 that respondent's financial position and the consolidated financial position had been presented fairly therein, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year (R. 53, 68).

On its federal income tax return for 1963, respondent deducted both its Section 404(b) and Section 404(d) payments as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code (R. 54). The Commissioner allowed the former, but disallowed the latter (R. 55). In a unanimous reviewed opinion (R. 39–75), the Tax Court agreed with the Commissioner. It held that the Section 404(d) payments constituted a nondeductible capital investment in FSLIC, and that such payments could be deducted only when used to pay regular annual insurance premiums or to meet actual losses of FSLIC. A divided court of appeals reversed and held the Sec-

[14] Respondent's parent first become subject to FSLIC's accounting regulations as a result of the enactment on February 14, 1968, of P.L. 90–255, 82 Stat. 5, Sec. 2, which amended Section 408(b)(2) of the National Housing Act. Under the amendment, the parent corporation must file an annual statement with FSLIC.

tion 404(d) payments to be currently deductible business expenses (R. 76–84).

This Court granted the Commissioner's petition for certiorari on November 9, 1970 (R. 85).

INTRODUCTION AND SUMMARY

Section 162(a) of the Internal Revenue Code authorizes a deduction for "ordinary and necessary expenses" that are paid or incurred by a taxpayer during the taxable year in carrying on a trade or business. The quoted phrase has been the subject of elaboration by this Court on numerous occasions. See, *e.g.*, *Welch* v. *Helvering*, 290 U.S. 111; *Helvering* v. *Winmill*, 305 U.S. 79; *Deputy* v. *duPont*, 308 U.S. 488; *Interstate Transit Lines* v. *United States*, 319 U.S. 590; *Commissioner* v. *Tellier*, 383 U.S. 687. As early as the *Welch case, supra* at 113–116, the Court rejected the proposition that the sole criterion of deductibility should be that a payment is "necessary" and held that to obtain a deduction under the predecessor of Section 162(a) the taxpayer must establish that a payment is "ordinary" as well. More recently, in the *Tellier* case, *supra* at 689–690, the Court discussed the term "ordinary" as it appears in Section 162(a) and expressly held that its principal function is to distinguish "between those expenses that are currently deductible and those that are in the nature of capital expenditures * * *." The "necessary" requirement of Section 162(a) is not involved in this case; the only issue is whether respondent's Section 404(d) payments meet the "ordinary" standard as explicated by this Court.

An expenditure is not "ordinary" if it represents the cost of an item in the nature of a capital asset, even if it is forced upon a taxpayer by law or by economic circumstances.[15] There is no dispute between the parties on this point. As respondent put it in its brief in opposition (p. 17), "Compulsion, whether legal or economic, should have no bearing upon the question whether a payment is an expense or a capital expenditure."[16]

The essence of an ordinary business expense is that the benefit from the expense is derived and exhausted

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[15] See *Welch* v. *Helvering*, *supra*; *Woodward* v. *Commissioner*, 397 U.S. 572, 579, n. 8; *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444, 448 (C.A. 3); *Falstaff Beer, Inc.* v. *Commissioner*, 322 F. 2d 744, 745 (C.A. 5); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541, 544 (C.A. 7), certiorari denied, 368 U.S. 987, and cases cited therein; *Russell Box Co.* v. *Commissioner*, 208 F. 2d 452, 454–455 (C.A. 1); *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 598 (Ct. Cl.).

[16] In rejecting the government's position that Section 404(d) payments constitute capital outlays, the district court in *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, 304 F. Supp. 1072, 1080 (S.D. Fla.), pointed out that the instant case involves a state-chartered savings and loan association which is not required by law to insure its accounts with FSLIC, while the taxpayer in that case, a federally chartered institution, is required by statute to maintain FSLIC insurance. See n. 3, *supra*. Nothing turns on this distinction which goes only to the "necessary" requirement of Section 162(a). Respondent's Section 404(d) payments were "necessary" in that respondent represents in its advertisements that it is a member of FSLIC, and, in the opinion of its management, termination of coverage would cause a mass withdrawal of savings by depositors (R. 42). *Washington Federal* is now pending on the government's appeals in the Fifth Circuit (Nos. 29,189 and 29,665), and is being held in abeyance with decision to abide the outcome in the instant case.

within the taxable year. In contrast, a cost that "results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year * * *" is a capital outlay. Treasury Regulations on Income Tax (1954 Code), Section 1.461–1(a) (1) and (2) (Appendix A, *infra*, pp. 41–42),[17] See *Wells-Lee* v. *Commissioner*, 360 F. 2d 665 (C.A. 8); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541 (C.A. 7), certiorari denied, 368 U.S. 987; *Darlington-Hartsville Coca-Cola B. Co.* v. *United States*, 273 F. Supp. 229, 231 (D.S.C.), affirmed, 393 F. 2d 494, 496 (C.A. 4), certiorari denied, 393 U.S. 962. Respondent does not question the validity of this fundamental rule of taxation; the sole issue is whether the rule, as applied to the undisputed facts of this case, requires that respondent's Section 404(d) payments be capitalized.

Our position is that respondent's share in the Secondary Reserve, which is evidenced by the annual statements furnished by FSLIC and which earns interest each year based on FSLIC's return on its government securities, constitutes a capital interest in FSLIC. We think it is clear that the benefit of respondent's Section 404(d) payments is not exhausted within the taxable year of payment, but extends far into the future. That benefit is virtually certain to inure to respondent when its share of the Secondary Reserve is used, in accordance with the provisions of

[17] Section 1.446–1(a)(4)(ii) of the Treasury Regulations, which deals specifically with items of plant and equipment, similarly provides that such items "which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account."

Section 404(g) of the National Housing Act, to discharge its obligations for regular annual insurance premiums in future years. If, however, respondent does not recover its share in this manner, it will recover it in some other form in the future.

The sole risk that respondent faces with respect to its share of the Secondary Reserve is that it will be used to discharge FSLIC's obligations to meet its losses. Since FSLIC is required by law to exhaust all of its other resources before turning to the Secondary Reserve, that risk is minimal. In any case, just as the purchase price of stock in a commercial corporation may not be deducted currently simply because of the possibility that the capital it represents may ultimately be used to discharge the corporation's prior obligations, respondent's Section 404(d) payments are not converted from capital into ordinary costs by reason of the risk of loss.

Treatment of the Section 404(d) payments as a capital investment in FSLIC accords with the precedent most nearly in point and with the accounting requirements of the concerned federal and state regulatory authorities. It is, moreover, consistent with the treatment of the payments by respondent's parent, an unregulated corporation, whose financial statements, like respondent's, were certified as being in accordance with generally accepted accounting principles.

Respondent contends that since its liability for Section 404(d) payments is absolute, the annual system of accounting for tax purposes permits a current deduction. There is no merit to this contention. A cost

resulting in the creation of an asset having a useful life extending beyond the close of the taxable year may not be deducted merely because the liability therefor becomes fixed and final during the taxable year. Rather, such a cost must be allocated to the future years in which it produces a benefit, so that the income of all years is correctly reflected.

Likewise without merit is respondent's contention that its Section 404(d) payments are no different than its regular annual insurance premiums and therefore are deductible. This argument simply ignores the fact that while the benefit of respondent's Section 404(b) payments is exhausted within the taxable year of payment as current insurance coverage is provided, respondent retains significant rights in the Secondary Reserve which will provide a benefit in future years. That it cannot be predicted with precision in what future year the benefit of a Section 404(d) payment will be derived is of no significance; it is sufficient for present purposes that the benefit will not be exhausted in the year of payment. Nor is it of moment that respondent cannot easily convert its share of the Secondary Reserve into cash or other liquid assets. The restrictions on the transferability of respondent's share and its inability to control when the benefit from its share will be derived do not alter the fundamental capital character of that interest.

The provisions and legislative history of the National Housing Act and the Federal Home Loan Bank Act reinforce the conclusion that respondent's share of the Secondary Reserve constitutes a capital interest

in FSLIC. Congress amended those statutes in 1961 and first imposed the Section 404(d) payment requirement in order to meet FSLIC's need for additional temporary capital. The Section 404(d) mechanism accomplishes this purpose by requiring member institutions to furnish capital only until such time as FSLIC's Primary Reserve (its retained earnings) is increased to the desired level. Significantly, at the same time, Congress reduced the obligation of savings and loan associations to make permanent capital investments through the purchase of Federal Home Loan Bank stock.

In sum, the court of appeals erroneously allowed as an ordinary and necessary business expense a cost incurred by respondent in acquiring an income-producing capital asset. Its decision is unsound and should be reversed.

ARGUMENT

RESPONDENT'S SECTION 404(d) PAYMENTS CONSTITUTE NONDEDUCTIBLE CAPITAL OUTLAYS

1. SUCH PAYMENTS RESULT IN THE CREATION OF AN ASSET WITH A USEFUL LIFE EXTENDING SUBSTANTIALLY BEYOND THE CLOSE OF THE TAXABLE YEAR

When respondent makes a Section 404(b) payment to FSLIC, that payment becomes part of FSLIC's gross income and respondent has no further interest in it. There is no possibility, remote or otherwise, that respondent will recover the payment, and respondent has no right with respect to the payment other than the right to insurance coverage for the current year. Since, at the end of that year, the benefit to be derived from the payment will have been exhausted, it is proper that respondent deduct the pay-

ment as an ordinary and necessary business expense under Section 162(a).

The situation with respect to a Section 404(d) payment is entirely different. Although respondent must make such a payment, together with the Section 404(b) payment, to maintain current insurance in force, the similarity between the two types of payments ends there. Unlike Section 404(b) payments which ultimately are transferred to FSLIC's Primary Reserve (its retained earnings), Section 404(d) payments go directly into FSLIC's Secondary Reserve and are subject to use by FSLIC only in the unlikely event that they are needed to meet losses after FSLIC has exhausted all of its other funds.[18] In this sense, the Secondary Reserve is truly a capital account, for as the Tax Court observed (R. 66), "what, after all,

[18] Nothing short of a national catastrophe would ever cause FSLIC to use its Secondary Reserve to meet losses. This was apparent in 1962 when the Section 404(d) payment requirement was first imposed. Prior to 1962, FSLIC's lifelong net insurance losses had aggregated only 1.1 percent of its lifelong gross income, and its total expenses only 3.7 percent of such income. (R. 49, 59). The ratio of FSLIC's reserves to its potential liabilities had declined somewhat before 1962 principally because of the retirement of the government's stock in FSLIC. S. Rep. No. 778, 87th Cong., 1st Sess., pp. 2, 12; House Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and H.R. 7109, 87th Cong., 1st Sess., pp. 10, 39. The financial statements of FSLIC reveal no year in which its net insurance losses exceeded even its investment income, much less the annual premiums received each year and the Primary Reserve, both of which would have to be fully consumed before the Secondary Reserve could be utilized (R. 59). Moreover, unlike a private corporation, FSLIC, in the event of catastrophic losses, has a line of credit in the amount of $750,000,000 with the United States Treasury upon which it can draw (Section 402(i) of the National Housing Act (Appendix C, *infra*, pp. 50–51). And, it

is the capital account of any corporation if not a 'Secondary Reserve,' a pool of capital available to creditors in the event that the corporation's current income and retained earnings are not sufficient to satisfy their claims?"

Not only does the Secondary Reserve represent a pool of capital, but respondent has a clear and definite interest in that capital. Effective with the first Section 404(d) payment made by respondent, FSLIC has maintained a separate account showing respondent's pro rata share of the Secondary Reserve, and has forwarded annual statements to respondent evidencing its ownership interest therein (R. 35–38). Moreover, respondent's share of the Secondary Reserve is itself earning a return ranging from 3.15 to 4.23 percent annually (R. 35–38, 52). Under these circumstances, the Tax Court was correct in concluding that respondent's Section 404(d) payments result in the creation of an asset in the form of respondent's interest in the Secondary Reserve.

Pursuant to Section 404(g) of the National Housing Act, respondent's Section 404(d) payments and the income thereon are returnable to respondent at such times (beginning in 1970 and intermittently thereafter) as they are used to discharge its obligations to

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can levy additional assessments upon its members each year not to exceed ⅛ of one percent of the total amount of each member's accounts and creditor obligations. Section 404(c) of the National Housing Act (Appendix C, *infra*, p. 52). The Secondary Reserve becomes available for FSLIC's losses, only if and to the extent that "other accounts of the Corporation [FSLIC] which are available therefor are insufficient for such losses." Section 404(e).

pay ordinary annual insurance premiums.[19] Under FSLIC projections (see n. 9, *supra*), respondent is virtually certain, if it continues in existence, to recover the full value of its pro rata share of the Secondary Reserve in this manner. If, however, full value is not so recovered, respondent's share is returnable to it in cash upon its liquidation, or when the Primary Reserve alone reaches two percent of all insured accounts and creditor obligations of all insured institutions, an event now projected to occur in 1995 (see n. 9, *supra*).[20] And, respondent's interest in the Secondary Reserve is transferable to another association in a consolidation, merger, or bulk sale of its assets. In sum, respondent is incorrect in its assertion (Br. in Opp. 14) that the money it pays into the Secondary Reserve is "[i]n truth and substance * * * gone in the year in which it is paid * * *." Rather, as the undisputed facts of this case show, the benefit of respondent's Section 404(d) payments will inure to it, in one form or another, at a

[19] When, and to the extent so used, respondent would be entitled to an ordinary and necessary business expense deduction.

[20] Respondent claims (Br. in Opp. 3) that no insured institution will ever receive a cash refund of any portion of its share of the Secondary Reserve. This is incorrect. We are advised by FSLIC officials that some insured associations may receive a cash refund of their share of Secondary Reserve when the Primary Reserve reaches the two percent level. For example, if a particular savings and loan association's business grows faster than that of the average savings and loan association while Section 404(d) payments are being made, and grows slower than that of the average savings and loan association while such payments are being used to discharge regular annual insurance premiums, the Primary Reserve could reach the two percent level before that association's pro rata share of the Secondary Reserve is exhausted. The projection tables (R. 49, 50) which show

future time. This, we believe, requires treatment of the payments as capital outlays for tax purposes.

The remote possibility that the Secondary Reserve would be used to meet FSLIC's losses (see n. 18, *supra*) does not change the fact that respondent's interest therein is a capital asset. This risk is, as the Tax Court observed (R. 59), no greater than the risk of loss on any capital investment made by a stockholder in a commercial bank or insurance company. It is probably a good deal less. At all events, the risk does not entitle respondent to a current deduction, for the cost of a capital or depreciable asset may not be deducted at the time of acquisition, even if there is a strong possibility of a loss. See, *e.g.*, *Fall River Gas App. Co.* v. *Commissioner*, 349 F. 2d 515, 516–517 (C.A. 1); *Radio Station WBIR, Inc.* v. *Commissioner*, 31 T.C. 803, 814; *Paxton* v. *Commissioner*, 7 B.T.A. 92; *Lutz* v. *Commissioner* 2 B.T.A. 484.

Wichita State Bank & T. Co. v. *Commissioner*, 69 F.2d 595 (C.A. 5), certiorari denied, 293 U.S. 562, which arose on facts similar to those of this case, supports our position. At issue there was the tax status of contributions made by Texas State Banks to a guaranty fund of up to $5,000,000 for the benefit of depositors. In that case as in this one, each participating bank's pro rata share of the fund was returnable to it upon its withdrawal from the fund or upon its liquidation. The lower court had been persuaded that the contributions were ordinary and necessary business

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that Section 404(d) payments will be fully absorbed into the Primary Reserve are based on average projections for the entire industry.

expenses because they were paid pursuant to a definite liability fixed by law. *Wichita State Bank & Trust Co.* v. *Commissioner,* 27 B.T.A. 822. The court of appeals viewed the matter differently and held (p. 596):

> That fund [the permanent five million dollar guaranty fund] is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. * * * We think the contributions to $5,000,000 Guaranty Fund, while made annually instead of in a lump sum, were essentially capital investments and ought to be dealt with as such. * * *

The same reasoning is applicable here. The Section 404(d) payments made by respondent and others are "not intended to be lost or consumed," but are designed to provide a reservoir of capital until FSLIC's own earnings—its Primary Reserve—increase sufficiently to permit return of that capital to contributors to the fund.

Respondent's own treatment of its Section 404(d) payments also accords with the view that they constitute capital expenditures. Its balance sheets, which were certified by Peat, Marwick and Mitchell as being in accord with generally accepted accounting principles, show such payments as assets and the interest credited thereon as income (R. 53, 68–69). This treatment is in line with the "Uniform Classification of

Accounts" prescribed by the California Savings and Loan Commissioner (R. 22–26, 31–32, 52–53). See also United States Savings and Loan League, *Standard Accounting Manual for Savings and Loan Associations* (1966), p. 113. It is also consistent with the reporting requirements of the Federal Home Loan Bank Board. Respondent's accounting treatment cannot be dismissed as simply a product of regulatory compulsion. Its parent, which was not subject to accounting regulations, treated the assets and income identically in its financial statements, and these statements too were certified by Peat, Marwick and Mitchell.

We recognize, of course, that the federal and state accounting requirements are not conclusive in determining the proper tax treatment of the Section 404(d) payments. See *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 562. However, those requirements are entitled to some weight, *Pennsylvania Power & Light Co.* v. *United States*, 411 F.2d 1300, 1306 (Ct. Cl.), particularly in a case like this one, where, as the Tax Court pointed out (R. 68), the agencies involved would want to be certain that respondent's assets and income were not overstated. Given their concern in this regard, their determination that Section 404(d) payments may not be deducted currently can only be taken as a reflection of the economic fact that respondent's interest in the Secondary Reserve constitutes an income-producing asset generating benefits for future years. It strongly militates against respondent's position that for federal income tax purposes—and only for such purposes—Section 404(d) payments should be treated as currently deductible expenses.

Despite the foregoing considerations, the court below rejected the Tax Court's conclusion that respondent's Section 404(d) payments constitute capital expenditures, and instead followed the contrary decisions of the district courts in *First Federal Savings and Loan Association of St. Joseph* v. *United States*, 288 F. Supp. 477 (W.D. Mo.), appeal dismissed October 14, 1968, and *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, 304 F. Supp. 1072 (S.D. Fla.), pending on the government's appeals in the Fifth Circuit (Nos. 29,189 and 29,665), with decision to abide the outcome in the instant case. Insofar as the question of future benefit is concerned, five central themes seem to underly the decisions adverse to the government's position. The first of these is that since depositors are likely to close their accounts if a savings and loan association cancels its FSLIC insurance, a Section 404(d) payment "has to be made to stay in business" (R. 82). As we have already shown (p. 12, *supra*), and as respondent concedes (Br. in Opp. 17), the fact that a taxpayer's outlay is required by law or coerced by economic circumstances is irrelevant in determining whether the outlay represents an "ordinary" expense or a capital expenditure. Accordingly, we do not deal further with this aspect here.

The other themes stressed by the court below and the district courts are (1) that the demands of the annual system of accounting for tax purposes require treatment of the Section 404(d) payments as ordinary business expenses; (2) that Section 404(d) payments are the same as Section 404(b) payments, the only

difference being that there is a remote possibility of obtaining a return of the former payments; (3) that there is uncertainty as to when such payments may produce a benefit; and (4) that the insured institution has no control over the payments once they are made. But these considerations should not, individually or in combination, alter the conclusion that by making Section 404(d) payments respondent acquired something of value in the nature of a capital asset.

(1) The court of appeals reversed the Tax Court's decision because of what it believed were the demands of "the annual accounting concept of income determination and income tax assessment" (R. 79). This Court has stated that, under this concept, "each 'taxable year' must be treated as a separate unit, and all items of gross income and deduction must be reflected in terms of their posture at the close of such year." *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 384. See also *Security Mills Co.* v. *Commissioner*, 321 U.S. 281. In reliance on this principle, the Ninth Circuit followed the reasoning of the district court in *First Federal S. & L. Ass'n. of St. Joseph* v. *United States, supra*, 288 F. Supp. at 484–485, and held (R. 79–81) that since respondent's liability for the Section 404(d) payment presently in dispute was fixed and determinable in 1963, and in fact was paid during that year, respondent was entitled to a current deduction for the payment.

We submit that the court below has misunderstood the annual accounting concept. That concept is to be

applied in determining *when* an ordinary and necessary expense may be deducted. See *Dixie Pine Co.* v. *Commissioner,* 320 U.S. 516; *United States* v. *Anderson,* 269 U.S. 422. It has no bearing, however, on the question *whether* a particular cost is a deductible expense or a capital expenditure.[21] If a cost results in the creation of an asset having a useful life extending beyond the close of the year, the cost must be capitalized even if the taxpayer's liability is fixed before the end of the year, and even if payment is made within the year. See, *e.g., First National Bank in Wichita* v. *Commissioner,* 46 F. 2d 283 (C.A. 10); *Lots, Inc.* v. *Commissioner,* 49 T.C. 541, 550–551, affirmed on another issue, *sub nom. Christie* v. *Commissioner,* 410 F. 2d 759 (C.A. 5); *Paxton* v. *Commissioner,* 7 B.T.A.

[21] In Rev. Rul. 66–49, 1966–1 Cum. Bull. 36, the Internal Revenue Service ruled that Section 404(d) payments are not deductible when paid. Cf. Treasury Regulations on Income Tax (1954 Code), Section 1.162–13. It also ruled that the return on such payments is not taxable when credited but only when it is used to discharge a savings and loan association's obligation to pay regular annual insurance premiums, or when otherwise made available to the association without substantial restriction or limitation. As the Tax Court held (R. 70, n. 10), there is no inconsistency between these rulings. The question when the return is to be taken into income turns on the application of the doctrine of actual or constructive receipt in the case of a cash basis taxpayer, and, in the case of an accrual basis taxpayer, on whether all events have occurred to fix the taxpayer's right to the income. The question posed in this case—whether respondent's Section 404(d) payments are capital expenditures or deductible business expenses—depends, as we have said, on the wholly different issue whether the payments will provide a benefit in future years.

92; *Lutz* v. *Commissioner,* 2 B.T.A. 484.[22] That is the nature of a capital expenditure.

In its discussion of tax accounting principles, the majority of the court of appeals apparently proceeded on the assumption that respondent's Section 404(d) payments are a "recurring annual expense" (R. 82). This is incorrect as pointed out in the dissenting opinion (R. 83). Based on FSLIC's 1961 projections (R. 50), such payments would be required to be made in only 13 of the 34 years between 1962 and 1995 (see n. 9, *supra*). It is respondent's regular insurance premiums (its Section 404(b) payments), not its Section 404(d) payments, that are its "recurring annual expense." In attempting to justify its holding as somehow matching respondent's costs and revenues in accordance with tax accounting principles, the Ninth Circuit has formulated a rule that has exactly the opposite effect. For, under its decision, there

[22] In Section 461(f) of the Code, Congress carved out an exception to the general rule that an accrual basis taxpayer may not take a deduction until its liability for payment is finally determined. Under this provision, payments for liabilities may be deducted even though they are contested and thus are not final. The court of appeals inferred (R. 81–82) that since Congress has allowed a deduction for a contested liability where payment is made, the fact of payment is somehow relevant in characterizing a cost as an expense or a capital expenditure. No such inference is permissible. Section 461(f) itself provides that a deduction is allowable thereunder only if, *inter alia*, "but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer [of funds] (or for an earlier taxable year) * * *." Thus, a contested capital expenditure (as on a contract to build a new building) would not be deductible under Section 461(f), even though it was paid while the contest was pending.

would be some years in which savings and loan associations would receive two deductions, and others in which they would be entitled to no deduction at all, even though they would have the benefit of FSLIC insurance in all taxable years.

Proper tax accounting principles require that Section 404(d) payments be deducted only as they are used to discharge respondent's obligations for regular annual insurance premiums. Only in this manner will the costs of FSLIC insurance be matched against the revenues generated because such insurance is maintained. The very purpose of the regulatory rule requiring the capitalization of costs which provide a benefit extending beyond the close of the taxable year is to prevent the distortion of income that would occur if the costs relating to the income of a number of years were charged off against the income of a single year.[23] See *United States* v. *Ludey,* 274 U.S. 295, 300–301. That purpose would be thwarted if respondent is permitted to deduct its Section 404(d) payments in the years in which such payments are made.

[23] Rev. Rul. 69–382, 1969–2 Cum. Bull. 28, is fully consistent with this purpose. That ruling is applicable to employers who, as part of their current annual labor costs, must pay accident and health insurance premiums to provide deferred, as well as present coverage, for groups of employees, generally under labor contracts. The ruling permits a full deduction of those premiums if the portion not applied during the current year is no more than may be expected to be applied in providing retired life coverage in future years. The theory underlying the ruling is that since the full benefit of the employees' services is realized during the current year, the full cost of those services should be deducted during that year.

(2) It is true, to be sure, that both the Primary and Secondary Reserves of FSLIC are available to meet its future losses. But, to conclude from this that the Section 404(b) payments, which go into the Primary Reserve, and the Section 404(d) payments, which go into the Secondary Reserve, are the same is to ignore the significant differences between these Reserves and the very substantial rights that a savings and loan association enjoys with respect to the Secondary Reserve.

To the extent that the decision below is premised on the assumption that there is only a remote possibility that respondent will receive a future benefit from its Section 404(d) payments, we believe it is factually in error. As we have shown (see n. 18, *supra*), the Secondary Reserve will be used to meet FSLIC's losses, rather than to provide respondent a future benefit, only in the unlikely event of a total national catastrophe.[24] Indeed, respondent and other savings and loan associations have already begun to benefit from their prior Section 404(d) payments, for these payments are now being used to discharge their obligations for regular annual insurance premiums.

[24] As the Tax Court pointed out (R. 70), cases holding that an otherwise deductible payment is not rendered nondeductible merely because of a contingent possibility of recovery (see, *e.g.*, *Mel Dar Corp.* v. *Commissioner*, 309 F. 2d 525 (C.A. 9); *Burnet* v. *Hutchinson Coal Co.*, 64 F. 2d 275 (C.A. 4); *George K. Herman Chevrolet, Inc.* v. *Commissioner*, 39 T.C. 846; and *Electric Tachometer Corp.* v. *Commissioner*, 37 T.C. 158) are not relevant here. The principle of those cases applies only where the expenditure is conceded or determined to be an "ordinary" business expense.

Respondent's interest in the Secondary Reserve cannot properly be characterized as a deductible expense merely because its purpose in making Section 404(d) payments—to maintain FSLIC insurance in force—and the consequence of failing to make such payments—loss of such insurance— are the same as the purpose of making Section 404(b) payments and the consequence of not making those payments. With regard to both types of payments, respondent is seeking to insure the continuation and growth of its business, just as a manufacturing concern must purchase machinery and pay salaries to employees to continue its business and provide for its growth. The fact that such a concern's purpose in purchasing machinery and paying salaries is the same does not justify deduction of the cost of the machinery as an ordinary and necessary business expense. The identity of purpose in this case similarly does not justify deduction of respondent's Section 404(d) payments.[25]

[25] Respondent is not helped by holdings purporting to apply the rationale of *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, and permitting ordinary loss deductions on the sale or exchange of capital assets when purchased as an interim step in the acquisition of a temporary source of supply. See *Booth Newspapers, Inc.* v. *United States*, 303 F. 2d 916 (Ct. Cl.). See also *Smith & Welton* v. *United States*, 164 F. Supp. 605 (E.D. Va.); *Commissioner* v. *Bagley & Sewall Co.*, 221 F. 2d 944 (C.A. 2); *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090. Apart from considerations of whether such ordinary loss treatment serves the intendment of *Corn Products*, the *Corn Products* question is not reached in the instant case because respondent has neither sold nor exchanged its interest in the Secondary Reserve. Respondent argued below that capital contributions to the Federal National Mortgage Association are

(3) Any uncertainty as to the precise future time when a Section 404(d) payment will produce a benefit likewise does not affect the character of the payment. In differentiating between current expenses and capital expenditures, the critical question is whether the benefit of the cost will be exhausted in the current year or will extend substantially beyond the close of that year. At the end of any taxable year in which respondent makes a Section 404(d) payment, there is no uncertainty regarding the answer to this question. For example, at the end of 1963, the year here in issue, it was known with absolute certainty that the benefit from the Section 404(d) payment made by respondent during that year had not been exhausted or even impaired, but would be derived in full in a subsequent year. The remote possibility of consumption of the payment that had existed during the year was by the end of the year eliminated.[26] No more is

deductible as ordinary business expenses and urged that the same treatment must be afforded its interest in the Secondary Reserve. Respondent failed to note that those deductions resulted from losses on exchanges of mortgages for FNMA stock. See *McMillian Mortgage Co.* v. *Commissioner*, 36 T.C. 924. More importantly, such deductions are now permitted only by virtue of a special provision of the 1954 Code (Section 162 (d) (Sec. 8(a), Act of September 14, 1960, P.L. 86-779, 74 Stat. 998), effective December 31, 1959 (Sec. 8(d)), specifically limited to FNMA stock purchases, and excepting them from the general rule applicable to capital investments.

[26] In support of the decision below, respondent cited (Br. in Opp. 11) I.T. 2764, XIII-1 Cum. Bull. 45, and Rev. Rul. 62, 1953-1 Cum. Bull. 71, where the Internal Revenue Service ruled that a payment made by a commercial bank to the Federal Deposit Insurance Corporation (FDIC) for insurance is currently deductible even though, if the payment proves excessive based

necessary to require respondent to capitalize the payment. The fact that there is some uncertainty as to which future year the payment will benefit emphasizes the capital nature of the payment, and does not justify deduction of the payment in the year in which it is made.[27]

(4) Nor is a current deduction justified because, given respondent's need to continue FSLIC insurance in force, it does not have it within its power to recover its Section 404(d) payments whenever it wishes to do so—in other words, because the payments are not mere deposits. The payments are subject to the remote possibility of use by FSLIC to meet its losses; respondent's interest in the Secondary Reserve can be transferred only in accordance with FSLIC regula-

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on FDIC's income for the year of payment, the excess portion will be credited against the succeeding year's payment. These rulings are not in point. The credit given an insured commercial bank toward its next year's premium is little more than a method of refunding an excessive current premium. If the FDIC were able to determine at the end of the year the precise amounts of its expenses and losses, such a mechanism would be unnecessary because the adjustment could be made within the year. The Section 404(d) payments here in question are not comparable to the FDIC insurance premiums.

[27] The observation of the district court in *Washington Fed. S&L. Ass'n of Miami Beach* v. *United States*, *supra*, 304 F. Supp. at 1076, that it is "in the realm of pure speculation" whether and when a Section 404(d) payment will result in a benefit is incorrect. That there will be a future benefit is almost certain. Even if it were totally uncertain as to when, in the future, the benefit would be derived, a current deduction would not be allowable. However, the uncertainty is not as great as the district court suggested. FSLIC's estimates of the buildup of the Primary and Secondary Reserves have been quite accurate. See n. 9, *supra*.

tions or upon approval by FSLIC; and respondent will recover the payments in the normal course when the aggregate of the Primary and Secondary Reserves reaches the two percent level specified in Section 404 (g) of the National Housing Act, an event admittedly beyond respondent's power to control. But it does not follow because respondent's interest in the Secondary Reserve can be liquidated only in stated circumstances, that its Section 404(d) payments are ordinary business expenses, rather than capital expenditures. Contrary to the assumption implicit in the control argument, a capital cost is not converted into a deductible expense merely because the cost may not easily be recovered through immediate conversion into cash or other assets. See, *e.g., Connecticut Light and Power Co.* v. *United States,* 368 F. 2d 233, 241–242 (Ct. Cl.); *Robertson* v. *Steele's Mill,* 172 F. 2d 817 (C.A. 4); *Gauley Mt. Coal Co.* v. *Commissioner,* 23 F. 2d 574, 578 (C.A. 4); *J. C. Cornillie Co.* v. *United States,* 298 F. Supp. 887, 896–897 (E.D. Mich.); *Lutz* v. *Commissioner,* 2 B.T.A. 484.[28]

[28] In *Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States*, *supra*, 304 F. Supp. at 1078, the district court relied on the Eighth Circuit's decision in *United States* v. *Weber Paper Co.*, 320 F. 2d 199, as authority for the proposition that control is to be taken into account in characterizing a cost as a deductible expense or a capital expenditure. Apart from the fact that we do not agree with that decision (Rev. Rul. 64–72, 1964–1 Cum. Bull. (Part 1) 85), we do not think that the case can properly be so read, since the government did not contend that the premium payments there in issue were capital expenditures. Rather, the government's argument was that even though the payments were ordinary and necessary business expenses, they were not paid or incurred during the

Respondent argues (Br. in Opp. n. 2) that, by reason of the absence of control, its Secondary Reserve interest is "illusory." There is nothing illusory, however, about either the benefit respondent is presently receiving because a portion of its share of the Secondary Reserve is being used to discharge its current Section 404(b) obligation—with a corresponding deduction for the payment of that obligation—or the return respondent is earning on its share of the Secondary Reserve, which itself is added to respondent's interest therein. The restrictions and limitations to which respondent's Secondary Reserve interest is subject and the postponement of the beneficial enjoyment of the income do not affect the capital character of that interest. They suggest only that the interest is not as desirable a capital asset as it otherwise might be.[29]

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taxable year because of the taxpayer's retention of control. Any suggestion that the Eighth Circuit has adopted the control test is dispelled by its recent opinion in *M.F.A. Central Cooperative* v. *Bookwalter*, 427 F. 2d 1343, petition for a writ of certiorari pending, No. 824, this Term. In that case, the court held that Class C stock purchased by the taxpayer in a Bank for Cooperatives was a capital asset, despite restrictions on alienability comparable to those in the instant case.

[29] The district court in *Washington Fed. S. & L. Ass'n* v. *United States*, *supra*, distinguished *Wichita State Bank & T. Co.* v. *Commissioner*, 69 F. 2d 595 (C.A. 5), certiorari denied, 293 U.S. 562, on which we rely (see pp. 20–21, *supra*). It pointed out (304 F. Supp. at 1078–1079) that the taxpayer in that case, unlike respondent, had the choice either to insure depositors' accounts through the guaranty fund or to take out a bond, and therefore could withdraw its deposit at any time. While this is a factual distinction between the cases, nothing in the Fifth Circuit's opinion suggests that it was relevant to the court's decision that the payments to the guaranty fund constituted capital expenditures.

2. THE PROVISIONS AND BACKGROUND OF THE NATIONAL HOUSING ACT AND THE FEDERAL HOME LOAN BANK ACT SHOW THAT RESPONDENT'S INTEREST IN THE SECONDARY RESERVE IS A CAPITAL INTEREST

At the outset of its opinion (R. 55–56), the Tax Court stated that the issue presented here should not be decided by the description of a Section 404(d) payment in the National Housing Act—"an additional premium in the nature of a prepayment with respect to future premiums." It recognized (*ibid.*) that if this description were controlling, Section 404(d) payments would be treated as prepaid insurance premiums and would not be deductible in the year of payment.[30] But the court preferred to rest its decision on the nature and substance of what was acquired, rather than the label provided by a non-tax statute.[31] It accordingly made a detailed analysis of the provisions and background of the National Housing Act and the Federal Home Loan Bank Act. Consistently with this approach, it rejected respondent's contention that since Congress used the nomenclature of the insurance industry in the National Housing Act, and

[30] See, *e.g.*, *Commissioner* v. *Boylston Assn.*, 131 F. 2d 966 (C.A. 1); *Higgenbottom-Bailey-Logan Co.* v. *Commissioner*, 8 B.T.A. 566, 577; *Peters* v. *Commissioner*, 4 T.C. 1236, 1242. Although the rationale of *Waldheim Realty & Inv. Co.* v. *Commissioner*, 245 F. 2d 823 (C.A. 8), is arguably to the contrary, the holding there involved a situation where the taxpayer had, for more than forty years, treated prepaid insurance as an expense on its books.

[31] We note that although the Tax Court took care to differentiate between a prepaid insurance premium and a capital asset, a current deduction is denied for both on the same theory—that the cost incurred will provide a benefit in subsequent taxable years.

specifically provided for the buildup of "reserves," the Section 404(d) payments, which are added to the Secondary Reserve, must be treated as insurance premiums (R. 65).

Looking to the nature and substance of what was acquired, as the Tax Court did, respondent's Section 404(d) payments cannot be dismissed as "nothing more than an increase in the amount of the regular premiums" (*Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States, supra,* 304 F. Supp. at 1076). If Congress had been concerned that the ordinary insurance premiums payable under Section 404(b) were not adequate to provide insurance coverage or protect bank depositors, it could simply have increased the ordinary premiums when it amended the National Housing Act in 1961. See nn. 5, 18, *supra.* However, the ordinary insurance premiums were more than adequate. Prior to 1962, when the Section 404(d) payment requirement was first imposed, FSLIC's net insurance losses had aggregated only 1.1 percent of its gross income, and total expenses only 3.7 percent of such income (R. 49, 59). Congress was aware of these facts in 1961 and of the fact that FSLIC's losses had never exceeded even its investment income for any year (R. 65). Under these circumstances, it saw no need to increase ordinary insurance premiums and did not do so.

Congress also knew in 1961 that the ratio of FSLIC's reserves to its potential liabilities had declined somewhat because of the retirement of the government's stock in FSLIC. S. Rep. No. 778, 87th

Cong., 1st Sess., pp. 2, 12; H. Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and H.R. 7109, 87th Cong., 1st Sess., pp. 10, 39. It was concerned with this loss of capital and was faced with the problem of raising capital to replace it. Accordingly, as the Tax Court explained (R. 65), Congress set out to create a temporary pool of capital "which would serve as a buffer until the FSLIC had accumulated enough of its own income to bring its 'Primary Reserves,' the true insurance reserve, to the desired two percent level."

Finding that the capital represented by the insured associations' investments in Federal Home Loan Bank (FHLB) stock was more than adequate to cover existing mortgage obligations (see Hearings, *supra* at 9), Congress devised a plan whereby capital that would otherwise have been furnished FHLB for its stock would instead be channelled to FSLIC. It provided for Section 404(d) payments and at the same time lowered the FHLB stock purchase requirement from two percent to one percent of an association's aggregate unpaid loan principal. In doing so, it explained that for most member institutions the Section 404(d) "prepayment requirement would be approximately offset" by the resulting reduction in outlays for FHLB stock which members previously had been required to make. H. Rep. No. 823, 87th Cong., 1st Sess., p. 2; S. Rep. No. 778, 87th Cong., 1st Sess., pp. 1–2.[32]

[32] In addition, Congress provided that instead of collecting regular insurance payments under Section 404(b) until such time as FSLIC's Primary Reserve equalled or exceeded five percent of its potential liabilities, such payments would cease when the Reserve reached two percent of total insured savings

The action taken by Congress in establishing the Secondary Reserve thus was more than a "mechanical vehicle" for identifying unused additional ordinary premiums (*Washington Fed. S. & L. Ass'n of Miami Beach* v. *United States, supra,* 304 F. Supp. at 1076). Rather, it amounted to a new evaluation of the amounts which member institutions would be required to *spend* (the ordinary insurance premiums), to invest *permanently* (FHLB stock in the amount of one percent of aggregate unpaid loan principal), and to invest *temporarily* (the Section 404(d) payments). As the Tax Court observed (R. 64, 66–67), no sharp line of distinction can be drawn between the FHLB capitalization and the FSLIC Secondary Reserve. In contrast to the ordinary premiums designed to meet ordinary insurance costs and forever lost to member institutions in the year of payment, the payments placed in the Secondary Reserve and the amounts used to purchase FHLB stock represent investments in a special pool of capital which is maintained to afford depositors additional protection against losses of an extraordinary nature (R. 63–64).

If the similarities in their capital natures were otherwise debatable, further dispute is laid to rest by the provision that when a member institution is required to purchase additional FHLB stock (to stay abreast of the one percent requirement), its Section 404(d) payment is reduced by that amount. This credit is not theoretical. In 1964, respondent's Section

---

and creditor obligations of member institutions, and would not thereafter be required unless and until the Reserve fell below the two percent level.

404(d) payment would have been $1,234,929, except that an FHLB stock purchase credit of $784,100 reduced the required payment to FSLIC to $450,829 (R. 29). The Tax Court therefore was fully justified in its view (R. 67) as to the "fungibility" of FHLB stock payments and Section 404(d) payments and in its conclusion that respondent's interest in the Secondary Reserve, like its FHLB stock, constitutes a capital investment.[33]

The statutes and legislative history focus upon the role of Section 404(d) payments as part of the capital structure of FSLIC. The court below thought (R. 78-79) that the Tax Court gave excessive weight to the treatment of the payments by FSLIC as compared with the weight given to the payments from the standpoint of the institutions making them. We do not agree. To the extent that the legislative evidence casts light upon the nature of FSLIC's Secondary Reserve, it is as relevant as any other evidence in determining what respondent acquired when it made Section 404(d) payments.[34] In concluding to the contrary, the court below erroneously discounted strong evidence of legislative intent which reinforces the conclusion that the outlays in question represent capital expenditures.

[33] During the 30 years it has purchased FHLB stock, respondent has always treated such outlays as capital expenditures (R. 62).

[34] The converse of this Court's statement in *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 27, that "[i]f they are capital investments to one they are capital sales to the other" would seem to be true in the instant case.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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DECEMBER 1970.

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.461–1. *General rule for taxable year of deduction.*

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis

shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461–2. Where

a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

* * * * *

APPENDIX B

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. 6. [as amended by Sec. 509 of the National Housing Act, c. 847, 48 Stat. 1264, and Sec. 2 of the Act of June 27, 1950, c. 369, 64 Stat. 257, 12 U.S.C. (1958 ed.) 1426].

* * * * *

(c) The original stock subscription for each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the aggregate of the unpaid principal of the subscriber's home mortgage loans, but not less than $500. The board shall from time to time adjust the amount of stock held by each member so that, as nearly as possible, such member shall at all times have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the preceding sentence (but not less than $500). If the board finds that the investment of any member in stock is greater than that required under this section, upon application of such member, the bank shall pay such member for each share of stock in excess of the amount so required an amount equal to the value of such stock, or, at the election of the bank, the whole or any part of the payments which would be so made shall be credited upon the indebtedness of the member to the bank. In either such event, stock equal in value to the amount of the payment or credit, or both, as the case may be, shall be surrendered and canceled. No share of stock shall be surrendered and canceled if the effect of such surrender and cancellation would be to violate the provisions of section

10(c) requiring the amount of stock held by such member to equal at least one-twelfth of the outstanding advances to such member.

* * * * *

(l) Within one year after the enactment of this subsection, each member of each Federal Home Loan Bank shall acquire and hold and thereafter maintain its stock holding in an amount equal to at least 2 per centum of the aggregate of the unpaid principal of such member's home mortgage loans, home-purchase contracts, and similar obligations, but not less than $500. Such stock in excess of the amount hereby required may be purchased from time to time by members and may be retired from time to time as heretofore. One year after the enactment of this subsection, each Federal Home Loan Bank shall retire and pay off at par an amount of its stock held by the Secretary of the Treasury equivalent to the amount of its stock held by its members in excess of the amount required to be held by them by the first two sentences of subsection (c) of this section immediately prior to the enactment of this subsection and annually thereafter each Federal Home Loan Bank shall retire an amount of such Government stock equivalent to 50 per centum of the net increase of its stock held by members since the last previous retirement: *Provided*, That none of such Government capital shall at any time be retired so as to reduce the aggregate capital stock, reserves, surplus, and undivided profits of the Federal Home Loan Banks to less than $200,000,000: *Provided further*, That notwithstanding any provision of this subsection, nothing in this subsection shall limit or affect the operation of subsection (g) of this section.

National Housing Act, c. 847, 48 Stat. 1246:

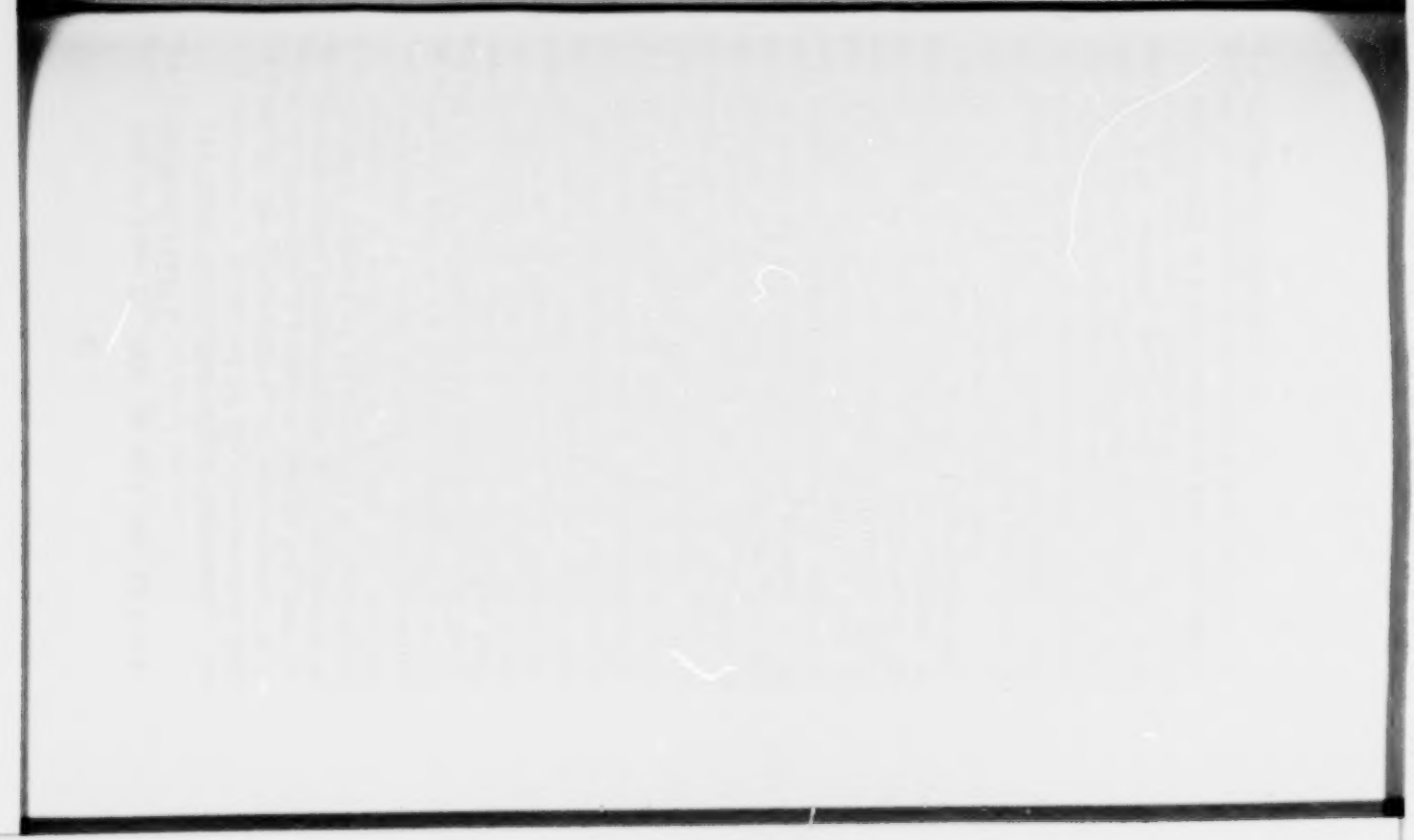
SEC. 404 [as amended by Sec. 25, Act of May 28, 1935, c. 150, 49 Stat. 298, and Sec. 7 of the

Act of June 27, 1950, 64 Stat. 259, 12 U.S.C. (1958 ed.) 1727].

(a) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium charge for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually until a reserve fund has been established by the Corporation equal to 5 per centum of all insured accounts and creditor obligations of all insured institutions; except that under regulations prescribed by the Corporation such premium charge may be paid semiannually. If at any time such reserve fund falls below such 5 per centum, the payment of such annual premium charge for insurance shall be resumed and shall be continued until the reserve is brought back to such 5 per centum. For the purposes of this subsection, the amount in all accounts of insured members and the amount of creditor obligations of any institution may be determined from adjusted statements made within one year prior to the approval of the application of such institution for insurance, or in such other manner as the Corporation may by rules and regulations prescribed.

(b) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except that the total amount so assessed in any one year against any such institution shall not exceed one-twelfth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

* * * * *



APPENDIX C

Federal Home Loan Bank Act, c. 522, 47 Stat. 727:

SEC. 6. [as amended by Sec. 1 of the Act of September 8, 1961, P.L. 87–210, 75 Stat. 482, 12 U.S.C. 1426].

* * * * *

(c)(1) The original stock subscription of each institution eligible to become a member under section 4 shall be an amount equal to 1 per centum of the subscriber's aggregate unpaid loan principal, but not less than $500. The bank shall annually, as of the close of the calendar year, adjust, at such time and in such manner and upon such terms and conditions as the Federal Home Loan Bank Board may by regulations or otherwise prescribe, the amount of stock held by each member so that such member shall have invested in the stock of the Federal Home Loan Bank at least an amount calculated in the manner provided in the next preceding sentence (but not less than $500). If the bank finds that the investment of any member in stock is greater than that required under this subsection it may, unless prohibited by said Board or by the provisions of paragraph (2) of this subsection, in its discretion and upon application of such member retire the stock of such member in excess of the amount so required. Said Board, in its discretion, may, by regulations or otherwise, provide for adjustments in amounts of stock to be issued or retired in order that stock may be issued or retired only in entire shares.

* * * * *

National Housing Act, c. 847, 48 Stat. 1246:

SEC. 402. [as amended by Sec. 6 of the Act of June 27, 1950, c. 369, 64 Stat. 259, 12 U.S.C. 1725].

* * * * *

(i) The Corporation is authorized to borrow from the Treasury, and the Secretary of the Treasury is authorized and directed to loan to the Corporation on such terms as may be fixed by the Corporation and the Secretary, such funds as in the judgment of the Home Loan Bank Board are from time to time required for insurance purposes, not exceeding in the aggregate $750,000,000 outstanding at any one time, and the Corporation hereafter shall not exercise its borrowing power under the first sentence of subsection (d) of this section for the purpose of borrowing money from any other source: *Provided,* That each such loan shall bear interest at a rate determined by the Secretary of the Treasury, taking into consideration the current average rate on outstanding marketable obligations of the United States as of the last day of the month preceding the making of such loan: *Provided further,* That nothing in this subsection shall prevent the Corporation from issuing debentures in accordance with the provisions of subsection (b) of section 405. For the purposes of this subsection the Secretary of the Treasury is authorized to use as a public-debt transaction the proceeds of the sale of any securities hereafter issued under the Second Liberty Bond Act, as now or hereafter in force, and the purposes for which securities may be issued under the Second Liberty Bond Act, as now or hereafter in force, are hereby extended to include such loans. Any such loan shall be used by the Corporation solely in carrying out its functions with respect to such insurance. All loans and repayments

under this subsection shall be treated as public-debt transactions of the United States.

SEC. 404. [as amended by Secs. 3, 4, 5, and 6 of the Act of September 8, 1961, *supra*, 12 U.S.C. 1727].

(a) The Corporation shall establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) and the credits made pursuant to the first sentence of subsection (e).

(b)(1) Each institution whose application for insurance is approved by the Corporation shall pay to the Corporation, in such manner as it shall prescribe, a premium for such insurance equal to one-twelfth of 1 per centum of the total amount of all accounts of the insured members of such institution plus any creditor obligations of such institution. Such premium shall be paid at the time the certificate is issued by the Corporation under section 403, and thereafter annually, except that under regulations prescribed by the Corporation such premium may be paid semiannually.

(2) If, at the close of any December 31, the Primary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions as of such close, no premium under paragraph (1) of this subsection shall be payable by any insured institution with respect to its premium year beginning during the year commencing on May 1 next succeeding such December 31, except that the foregoing provisions of this sentence shall not be applicable to any insured institution with respect to any of the twenty premium years beginning with the premium year commencing with the date on which such certificate is issued.

(3) The Corporation is authorized to pre-

scribe such rules and regulations as it may determine to be necessary or appropriate to accomplish the purposes and provisions of this subsection.

(c) The Corporation is further authorized to assess against each insured institution additional premiums for insurance until the amount of such premiums equals the amount of all losses and expenses of the Corporation; except that the total amount so assessed in any one year against any such institution shall not exceed one-eighth of 1 per centum of the total amount of the accounts of its insured members and its creditor obligations.

(d) Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 6 of the Federal Home Loan Bank Act and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve: *Provided*, That in the case of an insured institution which was not an insured institution at the beginning of such next preceding calendar year the 2 per centum aforesaid shall be 2 per centum of the net increase in all accounts of its insured members during that part of said calendar year which begins with the close of the day on which

such institution becomes an insured institution and the amount deducted from such 2 per centum under the foregoing provisions of this sentence shall not exceed one-half of such 2 per centum as calculated in accordance with this proviso. The Federal Home Loan Bank Board shall by regulations or otherwise provide for the furnishing to the Corporation of all necessary information with respect to Federal Home Loan Bank stock.

(e) The Corporation, in accordance with such regulations as it may prescribe, shall credit to the Secondary Reserve, as of the close of each calendar year a return on the outstanding balances of the Secondary Reserve during such calendar year, as determined by the Corporation, at a rate equal to the average annual rate of return to the Corporation during the year ending at the close of November 30 of such calendar year, as determined by the Corporation, on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States. Except as provided in subsections (f) and (g), the Secondary Reserve shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses. No right title, or interest of any institution in or with respect to its pro rata share of the Secondary Reserve shall be assignable or transferable, whether by operation of law or otherwise, except to such extent as the Corporation may by regulation or otherwise provide for transfer of such pro rata share in cases of merger or consolidation, transfer of bulk assets as defined by the Corporation by regulation or otherwise for the purposes of this sentence, and similar transactions as so defined.

(f) If (i) the status of an insured institution as an insured institution is terminated pursuant

to any provision of section 407 or the insurance of accounts of an insured institution is otherwise terminated, (ii) a conservator, receiver, or other legal custodian is appointed for an insured institution under the circumstances and for the purpose set forth in subdivision (d) of section 401, or (iii) the Corporation makes a determination that for the purposes of this subsection an insured institution has gone into liquidation, the obligation of such institution to make prepayments under subsection (d) of this section, including any prepayments as to which such institution is obligated at the time of such termination, appointment, or determination, shall cease, and the Corporation shall pay in cash to such institution its pro rata share of the Secondary Reserve, in accordance with such terms and conditions as the Corporation may prescribe by regulations or otherwise, or, at the option of the Corporation, the Corporation may apply the whole or any part of the amount which would otherwise be paid in cash toward the payment of any indebtedness or obligation, whether matured or not, of such institution to the Corporation, then existing or arising before such payment in cash: *Provided,* That such payment or such application need not be made to the extent that the provisions of the exception in the last sentence of subsection (e) are applicable. The Corporation in its discretion may provide by regulations or otherwise for the reinstatement in whole or in part, upon such terms and conditions as to payment or otherwise as it may prescribe, of the pro rata share of an institution in the Secondary Reserve in the event that such status or such insurance is restored by action of the Corporation or of a court in reversing or setting aside such termination, or in the event that, after such appointment or such determination, an institution is restored to operation as an insured institution, and for the payment, waiver, or other treatment

in whole or in part of any prepayments which, in the absence of the first sentence of this subsection, would have accrued under subsection (d) or would be payable thereunder.

(g) If, at the close of any December 31, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2 per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions but the Primary Reserve does not equal or exceed such 2 per centum, no insured institution shall be obligated to make any prepayment under subsection (d) during the year beginning with May 1 next succeeding such close, and each insured institution's pro rata share of the Secondary Reserve shall be used, to the extent available, to discharge such institution's obligation for its premium under subsection (b) for the premium year beginning in such year; and the suspension of obligation to make such prepayments and the use of such pro rata shares as provided in this sentence shall continue unless and until the next sentence or the last sentence of this subsection shall become operative. If, at the close of any December 31 occurring before the last sentence of this subsection shall become operative, the aggregate of the Primary Reserve and the Secondary Reserve is not at least equal to 1¾ per centum of the total amount of all accounts of insured members and creditor obligations of all insured institutions, (i) the obligation of insured institutions to make prepayments under subsection (d) shall resume on May 1 next following such December 31 and shall continue unless and until the first sentence or the last sentence of this subsection shall become operative, and (ii) the use of any insured institution's pro rata share of the Secondary Reserve under the first sentence of this subsection shall terminate with respect to its premium under subsection (b) for the premium

year beginning during the calendar year commencing on May 1 next succeeding such December 31, and such termination shall continue unless and until the first sentence of this subsection shall become operative. If, at the close of any December 31, the Primary Reserve equals or exceeds such 2 per centum, the Corporation shall, at such time (which shall be the same for all insured institutions and shall not be later than May 1 next succeeding such close) and in such manner as the Corporation shall determine, pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not, after such time, accept or receive further prepayments under subsection (d).

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IN THE

Supreme Court of the United States

October Term, 1970
No. 544

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

LINCOLN SAVINGS AND LOAN ASSOCIATION,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

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On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR THE RESPONDENT.

Introduction.

The petitioner's statements of the "Opinions Below", "Jurisdiction", and "Question Presented" appear adequate. With respect to the "Statutes And Regulations Involved", in addition to those set forth in Appendices A, B and C of petitioner's brief, respondent believes the following are pertinent to the case:

Internal Revenue Code of 1954 (26 U.S.C.):

"SEC. 263. CAPITAL EXPENDITURES.

(a) General Rule—No deduction shall be allowed for

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *"

Federal Home Loan Bank Act, c. 522, 47 Stat. 727 (12 U.S.C.):

"§ 1430. Advances—Authorization to make; limitation on amount

(a) Each Federal Home Loan Bank is authorized to make advances to its members upon the security of home mortgages, or obligations of the United States, or obligations fully guaranteed by the United States, subject to such regulations, restrictions, and limitations as the Board may prescribe. Any such advance shall be subject to the following limitations as to amount:

* * *

(c) * * * At no time shall the aggregate outstanding advances made by any Federal Home Loan Bank to any member exceed twelve times the amounts paid in by such member for outstanding capital stock held by it, or made to a nonmember borrower exceed twelve times the value of the security required to be deposited under subsection (e) of section 1426 of this title."

National Housing Act, c. 847, 48 Stat. 1246 (12 U.S.C.):

§ 1725. Creation of Federal Savings and Loan Insurance Corporation

(a) There is created a Federal Savings and Loan Insurance Corporation (hereinafter referred to as the "Corporation"), which shall insure the accounts of institutions eligible for insurance as hereinafter provided, and shall be under the direction of the Federal Home Loan Bank Board and operated by it under such bylaws, rules, and regulations as it may prescribe for carrying out

the purposes of this subchapter. The principal office of the Corporation shall be in the District of Columbia.

* * *

§ 1726. Insurance of accounts and eligibility provisions

(a) It shall be the duty of the Corporation to insure the accounts of all Federal savings and loan associations, and it may insure the accounts of building and loan, savings and loan, and homestead associations and cooperative banks organized and operated according to the laws of the State, District, Territory, or possession in which they are chartered or organized.

* * *

§ 1730. Termination of insurance and enforcement provisions—Voluntary termination of insurance

(a) Any insured institution other than a Federal savings and loan association may terminate its status as an insured institution by written notice to the Corporation specifying a date for such termination.

* * *

(d) In the event of the termination of an institution's status as an insured institution, insurance of its accounts to the extent that they were insured on the effective date of such termination as hereinabove provided in subsection (c), less any amounts thereafter withdrawn, repurchased, or redeemed, shall continue for a period of two years, but no investments or deposits made after such date shall be insured. The Corporation shall have the right to examine such institution from

time to time during the two-year period aforesaid. Such insured institution shall be obligated to pay, within thirty days after the effective date of such termination, as a final insurance premium, a sum equivalent to twice the last annual insurance premium payable by it. In the event of the termination of insurance of accounts as herein provided the institution which was the insured institution shall give prompt and reasonable notice to all of its insured members that it has ceased to be an insured institution and it may include in such notice the fact that insured accounts, to the extent not withdrawn, repurchased, or redeemed, remain insured for two years from the date of such termination, but it shall not further represent itself in any manner as an insured institution. In the event of failure to give the notice to insured members as herein provided the Corporation is authorized to give reasonable notice."

Statement.

Respondent believes that the "Statement" submitted by petitioner contains certain conclusions and argumentative matters (particularly in the third, fourth and fifth paragraphs thereof (Br. pp. 4-5) and in the full paragraph on page 8 of petitioner's brief). The "Statement" also is believed to be inadequate in not setting forth the differing functions of the FHLB and the FSLIC.

Respondent hopes it will facilitate the Court's consideration to substitute its own brief "Statement."

Respondent, a state-chartered (California) savings and loan association, is a member of the Federal Home Loan Bank of San Francisco, and insures its depositors'

accounts through the Federal Savings and Loan Insurance Corporation ("FSLIC"). At all relevant times, respondent has been a subsidiary of First Lincoln Financial Corporation, a corporation whose stock is publicly held and traded over the counter. It filed its federal income tax return for 1963, the taxable year herein in question, using the cash receipts and disbursements method of accounting.

The Federal Home Loan Bank Act (12 U.S.C. 1421 *et seq.*) was approved July 22, 1932, "to provide a reservoir of credit for thrift and home-financing institutions" and to "provide additional liquidity and funds for mortgage lending." Federal Home Loan Bank Board Annual Report—1963, p. 9. [Ex. 38, p. 9.] Each member was required to purchase FHLB stock equal to 2 percent of its outstanding mortgages. Having thus purchased FHLB stock equal to 2 percent of its outstanding mortgages, the association became entitled to borrow from the FHLB sums equal to 12 times the amount thus paid in for FHLB stock. (12 U.S.C. 1430 (a) and (c) *supra.*) Thus, the purchase of stock of FHLB gave to an association additional lending capacity for home mortgages.

Respondent became a member of the FHLB on March 4, 1936. (Appendix, p. 15.)

The Federal Savings and Loan Insurance Corporation ("FSLIC") was created by Congress on June 27, 1934 "to instill public confidence in our financial institutions through the insurance protection of savings." Federal Home Loan Bank Board Annual Report 1963, p. 23. [Ex. 38, p. 23.]

The FSLIC is charged by statute to insure accounts of eligible savings and loan associations. (12 U.S.C. 1726(a), *supra.*)

Respondent became an insured institution of FSLIC on June 6, 1938. (Appendix, p. 15.)

Respondent and all other insured institutions were required prior to 1962 to pay to the FSLIC a premium equal to ½ of one percent of the total amount of their respective savings accounts and creditor obligations until "a reserve fund has been established by the Corporation equal to 5 per centum of all insured accounts and creditor obligations of all insured institutions." 12 U.S.C. 1727. (Pet.'s Br. App. B, p. 47.) Thereafter, no insurance premiums would be payable unless and until the reserve fund were to drop below such 5 percent.

Such insurance premiums are deductible as ordinary and necessary business expenses, as the petitioner concedes. (Br. pp. 3, 16-17.)

On September 8, 1961, Congress enacted Public Law 87-210, which amended both the Federal Home Loan Bank Act and The National Housing Act, effective January 1, 1962.

The statute as amended required the FSLIC to "establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) and the credits made pursuant to the first sentence of subsection (e)."

Under section 1727 (b)(1) as amended each insured association must continue to pay to the FSLIC a premium for such insurance equal to 1/12 of one percent of its insured savings deposits plus creditor obligations.

Under section 1727 (d) each insured institution "shall annually pay to the Corporation * * * an additional premium in the nature of a prepayment with respect to future premiums" equal to 2 percent of the net increase in its insured savings deposits, less an amount equal to any requirement for the purchase of stock of the FHLB, and "such prepayments shall be credited to the Secondary Reserve."

The amendment of the Federal Home Loan Bank Act reduced the FHLB stock purchase requirement from 2 to 1 percent of outstanding home mortgages.[1]

When at the close of any calendar year, the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions, the obligation of insured institutions to make Section 1727(d) payments is suspended until such aggregate amount falls below 1¾ percent of all insured accounts and creditor obligations; the obligation to make the Section 1727(d) payments is terminated forever when the amount in the Primary Reserve alone equals or exceeds two percent of all insured accounts and creditor obligations of all insured institutions. In any year in which the obligation to make Section 1727(d) payments is suspended, the pro rata share of each insured institution in the Secondary Reserve will be used, to

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[1]The Senate Report stated that the prepayments to the FSLIC would be offset, in approximately the same amounts, by such reductions in required FHLB stock purchases. S. Rep. No. 778, 87th Cong., 1st Sess. p. 2. As discussed hereinafter, this does not mean, as the Tax Court erroneously concluded, that the premium prepayments and the FHLB stock purchases serve the same purpose and are "fungible." They have nothing in common. The reduction in stock purchase requirement was to lighten the financial burden placed upon insured associations in requiring additional premium payments to the FSLIC.

the extent needed and available, to make Section 1727 (b) payments. Section 1727(g) (Pet's Br., Appendix C, pp. 55-56.)

According to FSLIC projections made in 1961, the aggregate of the Primary Reserve and the Secondary Reserve would equal or exceed two percent of all insured accounts and creditor obligations of all insured institutions by 1970, and the Primary Reserve itself would reach the two percent level in 1995 (R. 49-51.)

When the Primary reserve itself equals 2 percent of all insured accounts and creditor obligations, no premium under Section 1727(b) shall be payable by any insured institution except those in existence for less than twenty years, unless and until the primary reserve thereafter drops below such 2 percent.

During the year 1963 respondent received an insurance premium notice from the FSLIC and paid into the primary reserve of the FSLIC a premium under Section 1727(b) at the rate of 1/12th of 1 percent of its insured accounts and creditor obligations. During the same year respondent received a "Notice of Insurance Premium Prepayment" and paid into the secondary reserve of the FSLIC under Section 1727(d) the required amount, equal to 2 percent of its increase in savings accounts and creditor obligations.

Payments made by insured institutions into the secondary reserve of the FSLIC pursuant to Section 1727(d) have been credited on the books and records of the FSLIC directly to an account entitled "Secondary Reserve." Effective with the first payments pursuant to Section 1727(d) made by insured institutions, the FSLIC has maintained separate accounts for each insured institution showing, among other things, the

amount of payment pursuant to Section 1727(d), the interest credited by the FSLIC to the account pursuant to Section 1727(e), and the insured institution's pro rata share of the secondary reserve. Interest credited by the FSLIC to respondent's account was not reported on respondent's Federal income tax returns, nor was it added by the Commissioner to respondent's income upon audit of its returns. (Appendix, p. 17.)

Section 1727(e) of the statute provides that no right, title or interest of any institution in and with respect to its pro rata share of the secondary reserve shall be assignable or transferable, whether by operation of law or otherwise, except as provided by regulation for transfer in cases of merger, consolidation, or transfer of bulk assets, or similar transactions.

Sections 1727(f) and (g) provide that an insured institution may receive a cash refund of its pro rata share of the secondary reserve in the event that (1) its status as an insured institution is terminated, (2) a conservator, receiver, or other legal custodian is appointed for the purpose of liquidation, (3) the FSLIC determines that such institution has gone into liquidation, or (4) the primary reserve alone reaches 2 percent of all insured accounts and creditor obligations.[2]

Pursuant to regulations issued by the California Savings and Loan Commissioner and by the Federal Home Loan Bank Board, respondent reported its share of the FSLIC's Secondary Reserve as an asset on its balance sheets and on its published financial state-

[2]The estimates prepared by the FSLIC and submitted to the Senate Committee on Banking and Currency, and published as part of the Committee's report, were that there would be no premiums remaining in the secondary reserve at the time the primary reserve should reach the 2 percent level. S. Rep. 778, 87th Cong. 1st Sess.; Appendix, pp. 49, 50.

ments, and treated the interest credited on such share as income. [R. 53.] Respondent's parent, although not subject to federal or state accounting regulations, likewise treated respondent's share of the Secondary Reserve as an asset on its consolidated financial statements. The firm of Peat, Marwick, Mitchell & Co., certified public accountants, stated in their audits of respondent's financial statements and those of its parent for the years 1962 through 1966 that respondent's financial position and the consolidated financial position had been presented fairly therein, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. [R. 53, 68.]

On its federal income tax return for 1963, respondent deducted both its Section 1727(b) and Section 1727(d) payments as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code. [R. 54.] The Commissioner allowed the former, but disallowed the latter. [R. 55.] In a unanimous reviewed opinion [R. 39-75], the Tax Court agreed with the Commissioner. It held that the Section 1727(d) payments constituted a nondeductible capital investment in FSLIC, and that such payments could be deducted only when used to pay regular annual insurance premiums or to meet actual losses of FSLIC. A divided court of appeals reversed and held the Section 1727(d) payments to be currently deductible business expenses. [R. 76-84.]

This Court granted the Commissioner's petition for certiorari on November 9, 1970. [R. 85.]

Summary.

Respondent is a California savings and loan association. It encourages people to deposit their savings with it; and in turn it loans out the savings thus deposited to people who want to buy or build homes.

To encourage home building the Federal Government created the Federal Home Loan Bank System, so that savings and loan associations such as respondent could invest money in the stock of FHLB and thereby become entitled to borrow from the FHLB twelve times the amount thus invested in FHLB stock, thus greatly increasing the funds which respondent could in turn loan out to home buyers or builders.

This was and is the primary purpose and function of the FHLB—to provide funds which savings and loan associations in turn can loan on mortgages. The FHLB had and has nothing whatever to do with insurance.

But, on the other hand, it is an important part of respondent's business to be able to assure its savings depositors that the Federal Government stands behind their savings.

The technique of furnishing this assurance was the creation of the FSLIC, an agency of the Federal Government, distinct from the FHLB although supervised by it, which was charged with the statutory duty of insuring the savings accounts of any depositor of an insured savings and loan association up to $5,000 initially, later increased to $10,000 and $15,000 and now to $20,000.

The FSLIC is in effect a mutual insurance company. It has no capital stock outstanding and has no authority from Congress to obtain any capital stock.

Its sole duty is to insure the savings accounts of depositors in insured institutions, and to do so it must have a reserve for insurance losses, which losses it has been required by statute to assume.

The building up of such a reserve for insurance losses has been the function of premiums required by Congress to be paid to FSLIC by its insured members. The statutory duty of the FSLIC to insure savings accounts of insured associations exists only so long as each association pays to the FSLIC the premiums for such insurance prescribed by Congress.

Because of the very rapid increase in savings deposits during the Fifties, Congress in 1961 became alarmed at the inadequacy of the FSLIC's reserve for insurance losses. That is to say, its potential risk as an insuror had become inordinate in the light of the reserve which it held against such risk.

Congress proceeded in 1961 to solve the problem by requiring a more rapid build-up of the FSLIC's reserve for insurance losses. It did not do this by authorizing the FSLIC to issue stock, which would stand as a capital reserve, either temporary or permanent. There is no such authority in the statute. It should be noted here that the FSLIC was originally capitalized with stock issued to the Home Owners Loan Corporation. (Appendix, p. 16.) If Congress had intended to convert the FSLIC from what was essentially a mutual insurance company to a stock insurance company in 1961 it could easily have done so since there was good precedent for doing it. Instead, Congress decided to retain the basic characteristics of the FSLIC as a mutual insurance company and merely increase the reserves for losses through additional premiums.

The petitioner concedes that the initial premium is deductible for income tax purposes as an ordinary and necessary business expense.

The petitioner contests the deduction for income tax purposes of the additional premium, conceding that it was "necessary", but contending that it was not "ordinary", in the sense that it might produce a benefit in a future year or years.

Respondent respectfully urges that the payment of the additional premium was "ordinary" within any accepted meaning of that word, in that all those similarly situated chose to pay it—and that is the meaning of the word "ordinary" as enunciated by this Court.

The fact that a payment may produce a benefit in a future year or years is not the criteria for distinguishing between an expense deduction and a capital expenditure. In fact, innumerable expense deductions produce benefits in years subsequent to their payment —as indeed the initial or primary premium payments in this case will inevitably do.

The answer lies in the nature and purpose of the payment: was it really made primarily for insurance coverage, not only for the current year but for any future year or years in which a savings may occur, or was it really made as a capital investment in preference to other ways in which the respondent may have preferred to use the $882,636.86 required to be paid to the FSLIC.

Of the four courts that have passed upon the question, three have been persuaded that the payment was in essence an expense for current insurance protection; that any future benefit that may be derived therefrom was not only speculative but was no different

than the benefit that may be derived in the future from having paid the intitial or primary premium; that the association did not in fact or substance make a capital contribution to the FSLIC; that the so-called return on the Secondary Reserve account of an association is illusory, being nothing more than a bookkeeping entry of FSLIC transferring funds from the Primary Reserve to the Secondary Reserve, both of which combined must reach the 2 percent level before any benefit will accrue to anyone; and that the possibility of a refund of the Secondary Reserve to any association was so remote and contingent that, under decided cases, such possibility does not preclude the deduction in the year of payment. *Lincoln Savings and Loan Association v. Comm.*, (C.A. 9) 422 F. 2d 90; *Washington Fed. S. & L. Assn. of Miami Beach v. U.S.*, (S.D. Fla.) 304 F. Supp. 1072, appeal pending; and *First Fed. S. & L. Assn. of St. Joseph v. U.S.*, (W.D. Mo.) 288 F. Supp. 477.

Only the Tax Court reached a contrary conclusion. Its decision was based upon two fundamental errors: (1) it stressed that the payments "are not really insurance premiums, at least not in the year in which they are paid" (Appendix, p. 59); and (2) it brought itself to believe that there was a "fungibility" of the Secondary Reserve premium payments and FHLB stock investments (Appendix, p. 67.)

The plain fact is that respondent paid the $882,636.86 of secondary premiums to the FSLIC in 1963 solely because it had to do so in order to continue as an insured institution of the FSLIC. Had it not made the payment it would not have been insured by the FSLIC for the year 1963. To say that the payment

did not procure insurance coverage for the year of payment is simply wrong. Insurance coverage for the year of payment could not have been obtained without the payment.

The FSLIC annually sends the taxpayer two bills, one for the primary premium (which the petitioner concedes is a deductible expense) and one for the secondary premium. Both must be paid to maintain the insured status, and by making both payments and only by making both payments does the respondent maintain its insured status.

These are the precise elements that constitute the obtaining of "insurance coverage" in the year of payment. The primary premium payments, which the petitioner admits do provide current insurance coverage, contain precisely the same elements: they must be paid to maintain the insured status, their payment in fact maintains the insured status, their only purpose is to maintain the insured status, and failure to pay them would cause the termination of the insured status. If the primary premium payments provide current "insurance coverage," and if precisely the same compulsion to pay, purpose in paying and consequence of failure to pay exist with respect to the secondary premium payments, how can it be said that the secondary payments do not equally provide insurance coverage?

We shall address ourselves hereinafter to the Tax Court's error in attempting to make the secondary premium payments "fungible" with FHLB stock purchases. This exhibits a complete misunderstanding of the two distinct functions performed by the FHLB and the FSLIC, and indeed a statement of Congressional purpose diametrically opposed to the stated purpose of Congress.

ARGUMENT.

I.

The Secondary Reserve Premium Payment Was an Ordinary and Necessary Business Expense of Respondent.

The Internal Revenue Code levies an income tax upon the net income of all taxpayers, permitting them to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." (26 U.S.C. 162).

Pursuant to the Act of Congress under which it operates, respondent during the year 1963 responded to the Congressional directive that it "shall annually pay to the Corporation [FSLIC] * * * an additional premium in the nature of a prepayment with respect to future premiums * * * equal to 2 percentum of the net increase in all accounts of its insured members," amounting to an additional premium of $882,636.86.

Respondent deducted said sum of $882,636.86 in determining its net income for income tax purposes, as an ordinary and necessary expense of carrying on its trade or business.

Petitioner disallowed the deduction. Petitioner concedes that the payment was "necessary", but contends that the payment was not "ordinary".

Respondent respectfully submits that the payment was "ordinary" within any definition of that term and particularly within the meaning of "ordinary" heretofore given by this Court.

In the celebrated case of *Welch v. Helvering*, 290 U.S. 111, Mr. Justice Cardozo stated:

"* * * Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. *Kornhauser v. U.S.*, 276 U.S. 145. * * *"

In the present case there can be no question but that the payment of the secondary reserve premium was "ordinary" in the sense that all associatiions similarly situated did in fact pay it. The Annual Reports of the Federal Home Loan Bank Board disclose that total insured associations numbered 4,419 at December 31, 1963, 4,463 at December 31, 1964, 4,508 at December 31, 1965 and 4,510 at December 31, 1966. (Federal Home Loan Bank Board Annual Report—1963, p. 24 [Ex. 38, p. 24] 1964, p. 33 [Ex. 39, p. 33] —1965, p. 58 [Ex. 40, p. 58]—1966, p. 61, [Ex. 41, p. 61].) The FSLIC secondary reserve increased as follows:

December 31	Secondary Reserve
1962	$171,000,000
1963	365,000,000
1964	590,000,000
1965	812,000,000
1966	999,000,000

(Annual Reports, 1963 (p. 68), 1964 (p. 107), 1965 (p. 125), 1966 (p. 120)).

No insured association terminated its insured status during 1962, 1963, 1965 or 1966, and only one association did in 1964 in favor of a state insurance program. (Federal Home Loan Bank Board Annual Reports—1962 (p. 37)—1963 (p. 25)—1965 (pp. 58-59)—1966 (pp. 61-62).) And in 1966 occurred the only case in the history of the FSLIC in which it exercised its statutory authority to terminate insurance. Federal Home Loan Bank Board Annual Report—1966, pp. 61-62. [Ex. 41, pp. 61-62.]

It can only be concluded from the foregoing that payment of the secondary reserve premium was an "ordinary" expenditure to make.

II.

The Possibility of a Future Benefit Does Not Convert an Ordinary and Necessary Business Expense Into a Capital Expenditure.

Petitioner has constructed an argument to the effect that the benefits to be derived from a deductible business expense must be "exhausted" in the year of payment, whereas an expenditure, if it produces benefits that may be enjoyed in future years, must be capitalized.

We respectfully submit that there is no such rule in the tax law.

Many, many expenses are deductible though they produce benefits in future years.

One of the most obvious examples is found in one of the first cases cited by petitioner, *Commissioner v. Tellier*, 383 U.S. 687. The taxpayer there was convicted of securities fraud and had been sentenced to four and one-half years in prison. He expended sums to defend against the charges and the income tax case involved

the deductibility of the sums thus spent, although unsuccessfully.

This Court held that the amounts paid in defense were deductible as ordinary and necessary business expenses, saying:

> "* * * The legal expenses deducted by the respondent were not capital expenditures. They were incurred in his defense against charges of past criminal conduct, not in the acquisition of a capital asset. Our decisions establish that counsel fees comparable to those here involved are ordinary business expenses, even though a lawsuit affecting the safety of a business may happen once in a lifetime. *Welch v. Helvering, supra,* at 114. *Kornhauser v. U.S. supra,* at 152-153; * * *"

The important point here is that the payments in question were made to procure a benefit that would have inured far beyond the year of payment. The taxpayer was attempting to prevent his going to prison for four and one-half years. The expenses were incurred in an attempt to prevent that. The benefit obviously would have been keenly felt for four and one-half years, and probably during the lifetime of the taxpayer. Yet, this Court held that the payment was a currently deductible ordinary and necessary business expense.

Even more in point is the case of *Commissioner v. Heininger,* 320 U.S. 467, where the taxpayer was allowed a deduction for expenses incurred by him in resisting an order which threatened to terminate his business. An expense to save a business certainly will be of benefit far beyond the year of payment, yet the

expense was a deductible ordinary and necessary business expense.

Repairs are another type of expenditure which, though often substantial in amount and resulting in benefits over many future years, are currently deductible. The income tax regulations, Sec. 1.162-4, allow the deduction of such repairs if they "neither materially add to the value of the property nor appreciably prolong its life." But repairs are currently deductible although they may be of benefit throughout the existing life of the property repaired.

Again, the income tax regulations, Sec. 1.162-5, allow a deduction for education expense which "maintains or improves skills required by the individual in his employment or other trade or business" or "meets the express requirements of the individual's employer."

It seems obvious that expenses of education, such as lawyers today customarily incur under the worthwhile continuing education of the bar programs sponsored by the American Bar Association and local bar associations, will produce benefits extending beyond the year of payment for such education, and yet the costs are universally deducted as current business expenses.

But, to bring the matter closer to home:

In I.T. 2764, C.B. XIII-1, 1934, the question presented was whether amounts paid by member banks into the temporary Federal deposit insurance fund, created under the Banking Act of 1933, were deductible for income tax purposes. Because of the rash of bank failures, Congress in 1933 established a temporary Federal deposit insurance fund to cover a period of six months from January 1, 1934 to June 30, 1934. Mem-

ber banks were required to make payments into the fund in 1933. Upon the discontinuance of the fund on June 30, 1934, any unused portion of the temporary fund was to be returned ratably to the member banks. The Internal Revenue Service held as follows:

> "In the opinion of this office the amount actually paid into the fund, as distinguished from the amount subject to call, constitutes an ordinary and necessary business expense under section 23-(a) of the Revenue Act of 1932 and *is deductible by the bank in its return for the taxable year in which payment is made irrespective of the contingency whereby a part of the amount paid may later be returned to the member bank.* (G.C.M. 8474, C.B. IX-2, 281.) If a part of the amount paid into the fund and deducted as a business expense is returned to the taxpayer, the amount so returned constitutes income for the year in which received. (G.C.M. 10798, C.B. XI-2, 58)" (Emphasis supplied.)

From the close of 1933, the tax year in which the payments were made, *only six months* were to elapse before it would be known whether the payments would be returned to the member banks. Yet, because tax accounting must be conducted on an annual basis, the Internal Revenue Service held the payments deductible in 1933. By contrast, in the instant case an indefinite number of years may elapse before it becomes known whether any part of respondent's 1963 payment will or will not be recovered. It follows, *a fortiori,* that the payment in the instant case is deductible in 1963.

Nine years later, the Internal Revenue Service issued another pronouncement of the same rule, as applied to facts even more similar to the facts of the instant

case. In I.T. 3632. C.B. 1943, 114, State banks in Indiana were required to make annual payments to a newly created Public Deposits Insurance Fund. The law provided that at such time as the insurance fund might exceed a minimum amount fixed by the Board of Depositories, excess funds would be returned pro rata to the contributing banks. The Internal Revenue Service held as follows:

> "It is held that the assessments in question, which are fixed by the board for depositories and are required to be paid by Indiana banks into the treasury of the State of Indiana, are deductible for Federal income tax purposes as business expenses for the year in which paid or accrued. If, following the audit of the books of the Public Deposits Insurance Fund at biennial intervals, any part of the amounts paid into the State treasury (for the benefit of the fund) and deducted as business expenses is returned to a participating bank, the amount so returned is includible in gross income for the year in which received. (Cf. I.T. 2764, C.B. XIII-1, 45 (1934).)"

As early as 1927 the Board of Tax Appeals adopted and applied the same principle. In *First State Bank of Brackettville* (1927), 9 BTA 975, the Board rejected the Commissioner's contention that payments by a bank into the Texas Depositor Guaranty Fund were non-deductible because of the possibility of refunds being made to the bank. The Board stated:

> "The petitioner having paid the amount in question pursuant to a definite liability fixed by law, the contingent possibility of a refund of some or all of the amount so paid does not render the

amount a non-deductible item. It seems clear that if the right to the deduction is denied the petitioner, its net income for the year in question could not be rightly determined. . . . If the contingency ever arises upon which a refund is realized out of the payments made in 1920, the amount so realized should be treated as income for the year during which it is realized."

The Board also stated at page 979:

"It is clear, therefore, from the foregoing provision of law (providing for the distribution to the contributing bank of its pro rata share in the depositor guaranty fund upon voluntary liquidation) that during 1920 the petitioner was not entitled to any part of the amount paid into the fund. As a condition precedent to the possibility of a refund, the petitioner would have to voluntarily liquidate and pay all of the outstanding obligations to all depositors in full. There was no statutory authority under which a refund could be made so long as petitioner continued to do business, the fund by reason of the failure of member banks might become depleted to such extent that petitioner's reversionary interest in the amount paid in in 1920 would be entirely extinguished."

In *Alleghany Corporation* (1957), 28 T.C. 298, sums paid by the taxpayer in opposing reorganization plans were held to be deductible notwithstanding the Commissioner's argument that there existed a possible right of recovery of part or all of the expenses. The Court stated at page 305:

"Neither do we think the deductions claimed should be denied in the years in which they were

incurred simply for the reason that there was a possibility that at some future date petitioner might receive a reimbursement for some of the expenditures. One of the elementary principles of Federal income tax accounting is that income and deductions must be accounted for on an annual basis in accordance with the method of accounting employed by the taxpayer. See *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). Petitioner employed the accrual method and under that method is entitled to deduct expenses as they accrue. The case of *Richard A. Drachman*, 23 T.C. 558, cited by respondent, does not support his contention. In that case the taxpayer had been treated as a general creditor with respect to his claim for reimbursement and, accordingly, as a debtor-creditor relationship existed, the deduction was disallowed for the year in which the reimbursable payment was made. In the instant case, no debtor-creditor relationship existed as to any of the payments, there being only a contingent possibility of reimbursement."

The last sentence quote above has particular significance here. The fact of the matter is that there is no debtor-creditor relationship existing between the FSLIC and respondent with regard to the secondary reserve. We have noted above that the secondary reserve is not a liability of the FSLIC owing by it to respondent or any other creditor. It is a reserve available to the FSLIC to meet losses of the entire savings and loan industry. Any recovery by or future benefit to respondent is purely contingent.

In *Electric Tachometer Corporation* (1961), 37 T.C. 158, the Commissioner sought to disallow moving ex-

penses caused by condemnation proceedings upon the ground the taxpayer was attempting to procure reimbursement for such expenses from the state. But the Court allowed the expense deductions, stating at pages 161 and 163:

> "* * * However, an otherwise proper deduction should not be disallowed in the year in which it is paid or incurred because of the existence of a possibility that at some future date the taxpayer might receive a reimbursement therefor. * * *"
>
> * * *
>
> "Under these facts, the right to receive reimbursement was not sufficiently fixed to make the expenditure in the nature of an advance or something other than an expense incurred in petitioner's business. * * *"

The principle has been applied uniformly, whether its application would happen to favor a taxpayer or the Internal Revenue Service. Thus, in *George K. Herman Chevrolet, Inc.* (1963), 39 T.C. 846, income was taxed to the taxpayer upon its receipt of an item of advertising expense previously paid out, the taxpayer seeking to escape such result by contending that the initial payment did not constitute an expense because of the possibility of refund that actually ensued. But the Court taxed the recovery and reiterated the familiar rule at page 853 that an otherwise proper deduction should not be disallowed in the year it was paid or incurred because of the existence of a possibility that at some future date the taxpayer might receive a reimbursement therefor.

With respect to advertising expense, the principle which respondent believes to be controlling here is

well stated in *E. H. Sheldon & Co. v. Comm.* (C.A. 6, 1954), 214 F. 2d 654:

> "The effect of advertising, by its nature, is usually not limited to the year in which it is done, but has a useful life somewhat indefinite in the future. The fact that an expenditure produces something that has a useful life extending beyond the taxable year is clearly not the controlling test. *J. H. Collingwood*, 20 T.C. 132; *Perkins Bros. Co. v. Comm.*, 78 Fed. (2d) 152, C.A. 8th; *Marsh Fork Coal Co. v. Lucas*, 42 Fed. (2d) 83, C.A. 4th; *New Pittsburgh Coal Co. v. U.S.*, 200 Fed. (2d) 146, C.A. 6th. It has been held a number of times that advertising expense, even though incurred heavily in a certain year with resulting benefits over future years, is nevertheless a deductible expense for the year in which expended. *Northwestern Yeast Co.*, 5 B.T.A. 232; *Colonial Ice Cream Co., supra* [7 B.T.A. 154]; *F. E. Booth Co., supra* [21 B.T.A. 148]; *A. Finkenberg's Sons, Inc.*, 17 T.C. 973, 982-983; *Consolidated Apparel Co.*, 17 T.C. 1570, 1582; *Richmond Hosiery Mills v. Comm.*, 29 Fed. (2d) 262, C.A. 5th."

The most recent example of the rule that a possible or probable future benefit does not preclude a present deduction of a payment is contained in Rev. Rul. 70-577, issued November 16, 1970, I.R.B. 1970-46, 8:

> "It is held that a taxpayer who makes a lump-sum payment into the Wisconsin unemployment reserve fund during the current taxable year under the provisions of section 108.18 (7) of the Act is entitled to deduct such payment as an ordinary and necessary business expense in his Federal in-

> come tax return for that year, regardless of whether his books or accounts are kept on the cash receipts and disbursements method or on the accrual method, and notwithstanding the fact that such payment effects a reduction in the amount that would be paid in a year subsequent to the year in which paid. Furthermore, the fact that a payment made in the current taxable year may be credited under the Act to a prior year, does not affect its deductibility in the current taxable year for Federal income tax purposes."

Petitioner seeks to dismiss certain of the foregoing citations in footnote 24 of his brief (p. 28) by saying that they are irrelevant since the principle of the cited cases applies only where the expenditures are conceded or determined to be "ordinary" business expenses.

We submit that petitioner's attempted distinction is without merit. In each case the Commissioner sought to deny a current deduction upon the ground that the taxpayer might or probably would realize a benefit in a future year. That is exactly the argument of petitioner here. He does not question the fact that the payment is deductible. It is only a question of *when* it is deductible. In all of the above cases the Commissioner lost in his argument that a current deduction should be disallowed because of a possible future benefit. We submit he should likewise lose here.

In view of all the foregoing, we submit that the possibility of a future benefit does not preclude a present deduction for an ordinary and necessary business expense paid.

But we submit there is an even more fundamental fallacy in petitioner's argument regarding future benefits. And that is that the primary premium, which is concededly deductible, is as much responsible for any future benefit as the secondary premium.

The benefit to be derived in a future year will occur only when and if the primary reserve and the secondary reserve combined have reached 2 percent. Upon the occurrence of that event, who is to say that the benefit thereupon flowing to respondent was any more attributable to its payment of the secondary premium than to the payment of the primary premium? It seems impossible to deny that the benefit in that particular year would not have resulted if either premium had not been paid.

Moreover, when the primary reserve alone reaches 2 percent every insured association is going to enjoy the benefit of non-payment of premiums, and that benefit certainly will have been "purchased" by payment of primary premiums during the history of the FSLIC equally as well as the payment of secondary premiums. As a matter of fact conceivably there could be those in existence who will enjoy that future benefit and who never had occasion to be required to pay secondary premiums.

A. The Real Test Centers in the Nature and Purpose of the Payment.

It is interesting that the Internal Revenue Code contains a section allowing a deduction for all the ordinary and necessary business expenses paid or incurred in carrying on any trade or business, Sec. 162 (Pet's. Br. p. 41); and it also contains a section disallowing any deduction for capital expenditures. Sec. 263, *supra.*

The interesting point is that the petitioner contends that the payment in dispute here is a capital expenditure, and yet it does not even cite or quote the section of the Internal Revenue Code dealing with capital expenditures, namely, section 263.

One reason for this omission, we suspect, is that the payment in dispute here is not a capital expenditure within the meaning of section 263: it is not an amount paid out "for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

Taxpayers normally deduct the cost of capital expenditures by way of depreciation deductions under section 167 of the Internal Revenue Code, which allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or property held for the production of income.

We have rather a payment required by Congress to remain an insured member of the FSLIC. Whether a payment is a deductible expense or a capital expenditure, we repeat, is dependent upon the nature and purpose of the expenditure. As three courts have heretofore held, including the Ninth Circuit below, the nature and purpose of the payment in dispute here characterize it as an ordinary and necessary business expense.

III.

The So-Called "Return" Credited to the Secondary Reserve Is Illusory.

The petitioner emphasizes the fact that interest is credited to the secondary reserve, in support of the argument that the secondary premium payments are capital expenditures.

However, the interest thus credited is not available to the insured institutions, and even the Internal Revenue Service concedes that insured associations are not taxable upon such interest at the time of the crediting. Rev. Rul. 66-49, C.B. 1966-1, 36.

The legislative history is interesting on this point. The Chairman of the legislative committee of the U.S. Savings & Loan League testified that it would be desirable if the interest on secondary reserve payments were paid to the associations in cash, as dividends were received in cash on the FHLB stock. Instead, he had learned only the preceding evening that the bill did not provide for the payment of interest in cash, but simply a credit to the secondary reserve, which would remain subject to all the restrictions governing that reserve. And of course it would be subject to payment of insurance losses, if need be. He therefore volunteered to supply an amendment to provide for such cash payment of interest. H. Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and 7109, 87th Cong. 1st Sess., pp. 39-43.

However, it apparently was decided not to present such an amendment, and the observations of the witness appear to have fallen on deaf ears, for there was no change in the bill with respect to this matter.

Here, we submit, is additional evidence that Congress was concerned primarily with building up the insurance reserves of the FSLIC, and was not intending to provide for a capital investment which would provide a cash return to investors.

The FSLIC receives money—both primary and secondary premium payments—and it invests the money in Government bonds. It does not earmark the bonds, this bond as a primary reserve bond and that bond as a secondary reserve bond. Rather, it receives all the interest on all its Government bonds, treating it all as income. Then it credits a return to the Secondary Reserve as the statute requires. This credit is treated as an expense or a deduction from what it is pleased to call its income, with the result that the Primary Reserve, to which is credited its so-called net income, is reduced by exactly the same amount as is credited to the Secondary Reserve.

But this crediting has absolutely no effect upon the size of the combined Primary and Secondary Reserves. One is decreased, the other increased. The important point is that for all important purposes under the Act, *i.e.*, when the combined reserves reach 2 percent, the so-called return could be in either reserve. It wouldn't make any difference. And since the so-called return is not available for use to the taxpayer, as the Internal Revenue Service admits, it doesn't make any difference to the taxpayer either.

In other words, the crediting of a return from one reserve to the other is totally immaterial.

IV.

The Three Circumstances Under Which Respondent Could Recover the Insurance Premium in Controversy Are Such That They Do Not Render the Expense Non-Deductible.

There are only three circumstances under which any portion of the secondary reserve could conceivably be returned to respondent:

1. In the event of its voluntary liquidation.

2. In the event of its termination as an insured FSLIC institution.

3. In the event the primary reserve alone should ever reach 2 percent of all savings accounts and creditors obligations of all insured institutions.

We shall consider these three factors separately.

A. Recovery Conditioned Upon Voluntary Liquidation Does Not Convert an Expense Into an Asset.

We submit it would be grossly improper to treat an expenditure as an asset instead of an expense upon the theory that the expenditure might be recouped by going out of business and dissolving. Such a view would be completely contrary to proper accounting procedures and to decided cases.

In the well-known text of Montgomery's Auditing, Eighth Edition (The Ronald Press Company, New York, 1957), edited by partners of Lybrand, Ross Bros. & Montgomery, the principle is stated on page 94 that "financial statements are presumed to be those of a going concern". And in the book "Inventory of Generally Accepted Accounting Principles For Business Enterprises", an accounting research study by Paul Grady, published in 1965 by the American Institute

of Certified Public Accountants, Inc., we find the following under the heading "Going Concern" and in the chapter entitled "Basic Concepts To Which Accepted Accounting Principles Are Oriented" (p.27):

> "It is a commonplace that business activity has changed over the past century or so from a series of separate ventures to a pattern of continuous activity. As a consequence, a large part of accounting practice as well as theory is based on the presumption that the accounting entity will continue in operation and not be liquidated in the foreseeable future. In the absence of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely.
>
> "Corporate managements must view their operations as a continuing process. No enterprise of any consequence could operate from day to day under the cloud of expected liquidation. * * * All of these factors support the basic proposition that business management assume, and properly so, the indefinite continuation of operations."

Hence, we submit that under generally accepted accounting principles there should be disregarded any possibility of a return of an expenditure based upon the liquidation of the enterprise as a condition precedent to such return.

This is in accord with cases already cited. The Board of Tax Appeals in *First State Bank of Brackettville* (1927), 9 BTA 975, ignored such a possibility saying, "As a condition precedent to the possibility of a refund, the petitioner would have to voluntarily liquidate and pay all of the outstanding obligations to all depositors in full."

Thus, the first possibility of a return, *i.e.*, liquidation, cannot be relied upon to disallow an expenditure as an expense and to treat it as the acquisition cost of a capital asset.

B. Termination of Insurance Is a Business Impossibility and Does Not Convert an Expense Into an Asset.

Section 1730 of Title 12 of the United States Code provides that any insured institution "may terminate its status as an insured institution by written notice to the Corporation", in which event insurance of its accounts shall continue for a period of two years, such insured institution shall be obligated to pay, within thirty days after any such notice or order of termination, as a final insurance premium, a sum equivalent to twice the last annual insurance premium paid by it, and the institution shall give prompt and reasonable notice to all of its insured members that it has ceased to be an insured institution and it may include in such notice the fact that insured accounts remain insured for two years from the date of such termination, but it shall not further represent itself in any manner as an insured institution.

Respondent's senior vice president was asked what in his opinion would the consequences be if respondent mailed a notice of termination of its insured status to all its depositors, and he stated [Rep. Tr. 125-126]:

> "I think it would be a mass liquidation of the association. * * * there would just be a shell left after we sent the notice out. * * * I don't believe that if we sent such a letter out indicating that we were going to cancel this insurance that we could anticipate anything except the fact that we would have a mass liquidation and withdrawal of accounts."

In other words, giving notice of termination of its status as an insured institution would simply be impossible as a practical matter. It would be tantamount to suicide from a business standpoint. A right to recover insurance premiums under such dire circumstances must surely be disregarded in the practical realm of Federal income taxation. A right to recover a recurring expenditure only upon pain of going out of business brings into play the same rule of law discussed above, regarding voluntary liquidation. The treatment of an expenditure as an asset or as an expense must be founded upon the "going concern" concept, not a liquidating concept.

C. The Possibility of Refunds if the Primary Reserve Alone Ever Reaches 2 Percent Is Too Indefinite and Uncertain to Render an Expense Non-Deductible.

The plain fact is that Congress and the FSLIC estimated that there would be no such refund (Appendix, pp. 49-50) but that prior to 1995 all the secondary reserve would have been transferred to the primary reserve.

By way of summary, Rev. Rul. 66-49, C.B. 1966-1, 36, rules that the secondary premiums cannot be currently deducted because each such premium "is returnable to it, under specified circumstances."

We have shown that two of such circumstances are inadmissible in disallowing an expense deduction, being dependent upon the liquidation of the taxpayer, and the third is estimated to be non-existent.

We respectfully submit, therefore, that Rev. Rul. 66-49, C.B. 1966-1, 36, is wrong and should be rejected. It is also inconsistent within itself, recognizing that interest credited on the secondary reserve is not taxable

to the insured associations at the time of crediting, because subject to the very limitations and conditions which respondent contends are sufficient to preclude the secondary premium payments from being treated as capital investments. As the Ninth Circuit said below (Appendix, p. 80), "We also believe that the revenue ruling is inconsistent within itself."

V.

The Accounting Treatment Required by Regulatory Authorities Is Not Controlling.

The petitioner (Br. pp. 9, 14, 22) mentions the fact that the Secondary Reserve payments are required by both the Federal and California regulatory authorities to be accounted for as assets and that a certified public accounting firm certifies to its balance sheet as in conformity with generally accepted accounting principles. The petitioner, however, concedes that such requirements are not controlling.

This is understandable, for it was established at an early date, and has been adhered to consistently, that accounting prescribed by regulatory authorities is not controlling in federal income tax determinations.

> *Old Colony Railroad Company v. Commissioner* (1932), 284 U.S. 552, 52 S. Ct. 211, 76 L. Ed. 484.

And we can understand why the Government would not want to assert that a balance sheet certified to by a certified public accountant is binding for federal income tax purposes. For in every company of any magnitude a certified public accountant's certificate will have been issued, but the Internal Revenue Service is not the least deterred from attacking the result for tax purposes, asserting that income has been understated or deduc-

tions overstated. It cannot afford in this case to take the position that the actions either of the regulaotry bodies or the certified public accountants are determinative.

We are not sure why the Federal and California regulatory authorities require the secondary premium payments to be accounted for as assets. But they do, mistakenly, we believe. As a matter of fact, we believe the annual reports of the FHLB contain misrepresentations to the public. For example, the report for 1963 contains the following statement:

> "Savers in insured institutions have four major lines of protection against loss: (1) the substantial loss reserves of the institutions themselves which were in excess of $6.8 billion, or 7.8 percent of savings, as of December 31, 1963; (2) the Insurance Corporation's own reserves of over $944 million at year end." [Ex. 38, pp. 23-24.]

Now, this is just a plain duplication of so-called reserves, and it is repeated in subsequent annual reports of the federal agency. The reserves of the savings and loan associations include the so-called secondary reserve payments, because they are required by this same agency to set them up as assets on their books; and then the same regulatory agency includes the same secondary premium payments as part of its reserve as protecting the savers.

And the accountants do not do a whole lot better. Under their umbrella of "generally accepted accounting principles", they can professionally certify to a balance sheet that may be out of step with reality as long as a regulatory body has espoused it. *Inventory of Generally Accepted Accounting Principles For Business Enter-*

prises, accounting research study by Paul Grady, published in 1965 by the American Institute of Certified Public Accountants, Inc., 52; "The Accountants Are Changing The Rules", Louis, Fortune Magazine, June 15, 1968.

The discrepancy is emphasized by the fact that a national accounting firm feels free to certify respondent's balance sheet, while the General Accounting Office, charged with the duty of auditing the FSLIC, cannot express an opinion regarding the FSLIC balance sheet, as shown hereinafter.

VI.

The Case of Wichita State Bank and Trust Co. v. Comm. Is Irrelevant.

The petitioner (pp. 20-21) relies upon *Wichita State Bank & Trust Co. v. Comm.* (C.A. 5, 1934), 69 F. 2d 595, cert. den. 293 U.S. 562.

The respondent has no quarrel with the principle stated in the *Wichita* case. As the Court of Appeals stated:

> "The contributions to the permanent Guaranty Fund stand otherwise. That fund is not intended to be lost or consumed, but is to stand as a reservoir drawn on to provide prompt payment to depositors, but to be at once replenished by the special assessments. It is analogous to the capital of an insurance company. Each bank owns its pro rata part in it, which it ought ultimately to get back. This bank got back its share by withdrawal from the plan, and it appears that on appeal of the law other banks got back their share."

Thus the *Wichita* case involved a fund which was not intended to be disbursed in payment of insurance losses,

except temporarily, any such disbursement to be immediately replenished with special assessments. This factor clearly distinguishes that case from the present case. Furthermore in that case a bank could simply convert to a bond system and thereby obtain a refund of his assessment, as the taxpayer in that case actually had done. Moreover, the plan itself had been discontinued and the entire fund had been disbursed to the contributors. In the light of these distinguishing factors we do not believe the holding in the *Wichita* case is contrary to anything the respondent has asserted in this proceeding. In fact the case supports respondent, in its holding that the special assessments were deductible when paid and that the subsequent recovery of them constituted taxable income.

VII.

The Legislative History of the 1961 Amendment of the National Housing Act Shows Clearly That the Secondary Reserve Premiums Were Intended to Be True Insurance Premiums to Strengthen the Insurance Reserves of the FSLIC and Were Not Regarded as Capital Investments in the FSLIC.

The petitioner's second argument (Br. pp. 34-38) asserts that the legislative history of the 1961 amendment establishes that the secondary reserve premiums were not insurance premiums at all, but were in the nature of a *temporary* investment in the FSLIC, *i.e.*, a capital expenditure.

We respectfully submit that there is nothing in the legislative history to support petitioner's theory, but that in fact the legislative history supports only the conclusion that the secondary reserve premium is nothing but an insurance premium to add to the insurance re-

serves of the FSLIC and was not intended to be a capital investment—temporary or permanent—in the FSLIC.

The petitioner's argument appears to us to be based upon an error.

We quote from the petitioner's brief (pp. 35-36):

> "Congress also knew in 1961 that the ratio of FSLIC's reserves to its potential liabilities had declined somewhat because of the retirement of the government's stock in FSLIC. S. Rep. No. 778, 87th Cong., 1st Sess., pp. 2, 12; H. Hearings Before Subcommittee on Banking and Currency on H.R. 7108 and H. R. 7109, 87th Cong., 1st Sess., pp. 10, 39. It was concerned with this loss of capital and was faced with the problem of raising capital to replace it. Accordingly, as the Tax Court explained (R. 65), Congress set out to create a temporary pool of capital 'which would serve as a buffer until the FSLIC had accumulated enough of its own income to bring its 'Primary Reserves,' the true insurance reserve, to the desired two percent level.' "

It is also stated (p. 37) that "no sharp line of distinction can be drawn between the FHLB capitalization and the FSLIC Secondary Reserve"; and it is concluded (p. 38) that the Tax Court "was fully justified in its view, [R. 67] as to the 'fungibility' of FHLB stock payments and Section 404(d) payments."

Contrary to the petitioner's statement, we have found nothing whatever in Senate Report No. 778, 87th Cong., 1st Session, either on page 2 or page 12 (which pages are cited by the petitioner), or on any other pages of the report, indicating in any way that retirement of

FSLIC stock had caused its reserve ratio to decline or that the Section 404(d) payments were intended as a capital replacement for any such retired stock.

We sincerely hope this Court will not permit the perpetuation of the Tax Court's erroneous view regarding "fungibility." The FHLB stock and the FSLIC Secondary Reserve are as unfungible as any two things could be.

The Tax Court's opinion and the Commissioner's argument seem to disregard the fact that the FHLB and the FSLIC are separate and distinct entities; they were created for entirely different purposes and at different times; each performs a separate and distinct function, wholly unrelated to the other; and the financial structure of each bears no relationship to that of the other.

Because of the confusion created by the Tax Court's misconception, may we quote directly all that the Senate Committee stated at the beginning of its report under the heading "Purpose of the Bill" and "Background":

"PURPOSE OF THE BILL

This bill is designed to strengthen the Federal Savings and Loan Insurance Corporation which insures savings accounts in savings and loan associations and similar institutions up to a statutory limit of $10,000. Under the bill, supplemental payments would be required by insured associations in order to build up the Corporation's reserve fund. For most institutions, this prepayment requirement would be approximately offset by reducing the stock the institution must purchase in its Federal home loan bank.

Under present law, each insured institution is required to pay to the FSLIC an annual premium of one-twelfth of 1 percent of the accounts of its insured members and its creditor liabilities. Each member institution is also required to purchase stock in its Federal home loan bank amounting to 2 percent of the unpaid principal of outstanding home mortgage loans and other similar obligations.

Under the proposed law, such insured institution would be required to pay a premium prepayment equal to 2 percent of the annual net increase of the accounts of its insured members in addition to the usual one-twelfth of 1 percent annual premium. However, these prepayments to the Insurance Corporation would be offset, in approximately the same amounts, because the bill proposes to reduce the home loan bank stock purchase requirement to 1 percent of outstanding home mortgages and other similar obligations. This would suspend the requirement for additional stock purchases for most member institutions for a number of years.

Due to the rapid growth of insured institutions, the ratio of the Insurance Corporation's reserves to its potential liability has dropped in the past 11 years from 0.843 percent to 0.661 percent. While the reserves of the insured institutions (averaging abut 8 percent) constitute the primary bulwark against losses, and while the net insurance losses have absorbed only 1.1 percent of the Corporation's gross income during its entire life, there is general agreement that the Corporation's reserves should be built up at a faster rate.

Under the bill, prepayments of about $150 million a year are expected, in which case the

combined reserves of the Corporation would reach 1 percent by 1963 and about 1½ percent by 1966. It is considered that this increase in reserves would place the Insurance Corporation in an extremely strong position.

For many years it has been generally recognized that the Federal Home Loan Bank System is overcapitalized. Under the original law, the stock subscription requirement was 1 percent of the aggregate unpaid principal on outstanding mortgages. This was raised to the present 2 percent by legislation enacted in 1950 as a part of the program to accelerate the retirement of Government stock in the banks which has now been accomplished. As far back as 1955 the industry and the administration recommended a reduction of required stockholdings from 2 to 1 percent as provided in the proposed legislation before the committee.

Background

Federal Home Loan Bank System

The Federal Home Loan Bank Act of 1932 created the Home Loan Bank System. Under the authority of this act, 12 district home loan banks (reduced to 11 in 1946) were organized with capital subscribed by member institutions and by the U.S. Treasury. Funds for lending were obtained principally from borrowings on the open market and from retained earnings of the banks. The System was fundamentally designed as a reserve credit facility for savings and home mortgage credit institutions. Under the original law, each member institution of a Federal home loan bank required to hold stock in its bank equal to 1 percent of the aggregate unpaid principal of its

home mortgage loans, subject to a required minimum. By legislation enacted in 1950, as a part of the program for accelerating the retirement of the Government stock in these banks, the required amount of stock was approximately doubled, being increased to 2 percent of the aggregate unpaid principal of the member's home mortgage loans, home-purchase contracts, and similar obligations.

Federal Savings and Loan Insurance Corporation

The Federal Savings and Loan Insurance Corporation is a Government Corporation. It was created by the Congress through legislation approved by the President on June 27, 1934. The purpose of the Corporation is to provide safeguards for savings by insuring the accounts of each saver or investor in eligible institutions of the savings and loan type. In order to qualify for insurance, applicant institutions must fulfill specific requirements with respect to such features as management, financial policies, and financial condition.

The Federal Savings and Loan Insurance Corporation insures the savings of each member or investor in an insured institution up to $10,000. The Corporation operates under the direction of the Federal Home Loan Bank Board, and expenses are completely met from its income, which consists principally of premiums paid by savings and loan associations, interest on its investments, and admission fees."

We submit there could be no more clear enunciation of the distinct functions and purposes of the two entities. The FSLIC needed additional insurance re-

serves, and this need arose from "the rapid growth of insured institutions."

The Chairman of the FHLB testified that "The failure of the reserve ratio of the Corporation to increase during the intervening period is caused solely by the rapid growth of the insured institutions." H. Hearings Before Subcommittee on Banking and Currency on H. R. 7108 and H. R. 7109, 87th Cong., 1st Sess., p. 10.[3]

That the secondary payment was intended by Congress to be a true insurance reserve, rather than a replacement of capital, is emphasized in the following quotation from H. Rep. 823, 87th Cong., 1st Sess., p. 3:

> The bill will not affect the regular premiums paid into FSLIC until the Corporation's primary reserve (which means, roughly, the reserve which would be built up under present law without this bill) equals 2 percent of the accounts of insured savers plus the creditor obligations of insured insured institutions. FSLIC estimates this will happen sometime between 1993 and 1995. When that happens, premium payments will be suspended until the ratio drops below 2 percent, when they will be resumed.
>
> The premium prepayments required by the bill will be credited to a secondary reserve, available to pay any losses not covered by other FSLIC resources. When the primary and secondary re-

[3]Testimony of the chairman of the legislative committee of the U. S. Savings & Loan League mentioned retirement of FSLIC stock, but this was nowhere even mentioned by either Congressional Committee. See H. Rep. 823 and S. Rep. 778, 87th Cong., 1st Sess.

serves together reach the 2 percent level, the requirement for premium prepayments will be suspended until the ratio drops to 1.75 percent, when they must be resumed. FSLIC projections indicate the two reserves together will reach 2 percent for the first time in 1970. Thus, if the projections are correct, the bill would produce a 2 percent ratio about 25 years sooner than present law would.

Thus, the two reserves were intended to serve exatcly the same purpose—that of a reserve for insurance losses.

The two reserves are so treated by the FSLIC. In the FHLB Annual Report for 1963 (pp. 23-24) it was reported to the Congress and to the public that savings depositors were protected by certain factors, including:

> "the Insurance Corporation's own reserves of over $944 million at year end, *which are accumulating more rapidly than in the past under legislation passed by Congress in 1961*." [Ex. 38, pp. 23-24; emphasis added.]

The Comptroller General of the United States audits the FSLIC. In his report to the Congress of the United States dated May 23, 1967, covering the period July 1, 1963 through December 31, 1965, there is nothing whatever that would indicate that the secondary reserve serves any purpose different from that of the primary reserve, and on the balance sheets attached as part of the report the primary reserve and the secondary reserve are listed under the heading "Reserves" and their combined totals set forth. [Ex. 43, p. 29.] The report, under the heading "Opinion on Financial Statements", includes the following statement:

"The Corporation's primary and secondary reserves established pursuant to law are available to meet future losses. These reserves are not a measure of the insurance risk which is dependent on future economic conditions, and therefore the adequacy of these reserves is not determinable." [Ex. 43, p. 27].

And on page 2 of the letter of transmittal accompanying the report the following is stated:

"The financial statements accompanying this report have been prepared by the Federal Savings and Loan Insurance Corporation. Because we could not determine the adequacy of the primary and secondary reserve and the allowances for losses, and because the Corporation does not disclose in its financial statements the possible adverse effect that the impaired financial condition of certain insured associations might have on the Corporation's financial position and results of operations, we cannot express an overall opinion on the accompanying financial statements for the 18-month period ended December 31, 1964, and for the calendar year 1965."

We respectfully submit that as far as the Comptroller General is concerned the secondary reserve serves exactly the same purpose as the primary reserve. And the comment in his "Opinion on Financial Statement" serves to emphasize respondent's position that the secondary reserve is entirely beyond its control, "dependent on future economic conditions", rendering the adequacy of the reserves indeterminate.

Petitioner places emphasis upon the fact that the primary premiums are treated by the FSLIC as income,

whereas the secondary premiums are credited directly to the Secondary Reserve.

We fail to see any significance in such accounting treatment. Section 1727(d) specifies that the secondary premium shall be "credited to the Secondary Reserve", and hence the FSLIC is merely complying with the wishes of Congress in this accounting treatment. Such accounting is consistent with the Congressional mandate in Section 1727(e) that the Secondary Reserve "shall be available to the Corporation only for losses of the Corporation and shall be so available only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses."

But the crucial point is that the secondary premiums are available for losses. Thus they are nothing but insurance premiums. Whether they are accounted for as income of the FSLIC is utterly unimportant to respondent or other insured institutions. And it must likewise be immaterial to the FSLIC, since it is a nontaxable entity in any event.

Furthermore, as the Ninth Circuit stated below (Appendix, p. 78), "We think the emphasis upon the treatment of the receipt by the payee, FSLIC, is mistaken and that in determining whether an expense is an ordinary and necessary expense of doing business, the focus should be on the taxpayer and the taxpayer's business, not on what the payee does with the money paid. * * *"

The petitioner also refers repeatedly throughout its brief to the words "retained earnings", apparently referring to the primary premiums minus expenses and losses. We have searched the legislative history and the annual reports of the FHLB and have found no

mention of a concept of "retained earnings". This concept of "retained earnings" was apparently created by the Tax Court (Appendix, p. 66) as part of its attempt to equate the secondary reserve to a "pool of capital", thereby attempting to use the analogy of an ordinary commercial corporation, where there is a distinction between capital, on one hand, and surplus (including retained earnings).

But this analogy is wholly meaningless here. As shown above, the FSLIC is a non-stock, non-profit, mutual insurance company. The concepts of income and retained earnings are irrelevant. All that matters is that insurance premiums collected by the FSLIC, in excess of expenses and losses, constitute a reserve for insurance losses.

Conclusion.

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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NOTE: Where it is deemed desirable, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Lumber Co.*, 200 U.S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

COMMISSIONER OF INTERNAL REVENUE *v.* LINCOLN SAVINGS & LOAN ASSN.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 544. Argued February 23, 1971—Decided June 14, 1971

Payment by a state-chartered savings and loan association of the "additional premium" required by § 404 (d) of the National Housing Act to be paid to the Federal Savings and Loan Insurance Corp. is not deductible for income tax purposes as an ordinary and necessary business expense under § 162 (a) of the Internal Revenue Code.

422 F. 2d 90, reversed.

BLACKMUN, J., delivered the opinion of the Court, in which BURGER, C. J., and BLACK, HARLAN, BRENNAN, STEWART, WHITE, and MARSHALL, JJ., joined. DOUGLAS, J., filed a dissenting opinion.

NOTICE: This opinion is subject to formal revision before publication in the preliminary print of the United States Reports. Readers are requested to notify the Reporter of Decisions, Supreme Court of the United States, Washington, D.C. 20543, of any typographical or other formal errors, in order that corrections may be made before the preliminary print goes to press.

SUPREME COURT OF THE UNITED STATES

No. 544.—October Term, 1970

Commissioner of Internal Revenue, Petitioner, v. Lincoln Savings and Loan Association. | On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[June 14, 1971]

Mr. Justice Blackmun delivered the opinion of the Court.

This case presents the question whether the "additional premium" paid in 1963 by a state-chartered savings and loan association to the Federal Savings and Loan Insurance Corporation under the compulsion of § 404 (d) of the National Housing Act, as amended, 12 U. S. C. § 1727 (d),[1] is deductible by the association, for income

[1] Section 404 (d), as amended by the Act of September 8, 1961, Pub. L. 87-210, § 6, 75 Stat. 483, read:

"(d) Each insured institution, except as otherwise provided in this section, shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b) equal to 2 per centum of the net increase in all accounts of its insured members during the next preceding calendar year, less an amount equal to any requirement, as of the end of such calendar year, for the purchase of stock of the Federal Home Loan Bank of which such institution is a member, calculated in accordance with the provisions of subsection (c) of section 6 of the Federal Home Loan Bank Act and without regard to any net increase during such calendar year in its holdings of such stock, and such prepayments shall be credited to the Secondary Reserve . . . ."

The foregoing is the form of the statute in effect during 1963. Subsection (d) was further amended by the Act of September 21,

tax purposes, as an ordinary and necessary business expense under § 162 (a) of the Internal Revenue Code of 1954, 26 U. S. C. § 162 (a).

The Commissioner of Internal Revenue determined a deficiency of $461,454.38 in the 1963 cash basis federal income tax of Lincoln Savings and Loan Association. Nearly all the deficiency was attributable to the disallowance of a deduction claimed for Lincoln's payment of $882,636.86 made pursuant to § 404 (d). Lincoln sought redetermination in the Tax Court. Judge Raum, in a decision reviewed by the court without dissent, upheld the deficiency. *Lincoln S. & L. Assn.* v. *Commissioner*, 51 T. C. 82 (1968). On appeal the Ninth Circuit reversed, one judge dissenting. 422 F. 2d 90 (CA9 1970).[2] Because of the importance of the issue for the savings and loan industry and for the Government, we granted certiorari. 400 U. S. 901 (1970).

I

The pertinent facts are not in dispute. Lincoln is a California savings and loan association organized in 1925 and is licensed under state law. It is subject to Division 2 of the California Financial Code, West's Ann. Cal. Fin. Code § 5000, *et seq.*, and is also subject to the regulations of the State's Savings and Loan Commissioner. California Administrative Code, Tit. 10, c. 2.

In 1936 Lincoln applied for membership in the Federal Home Loan Bank of San Francisco (then of Los Angeles).

1968, Pub. L. 90–505, § 6 (a), 82 Stat. 858, and by the Act of December 24, 1969, Pub. L. 91–152, § 416 (c) (1), 83 Stat. 401, in ways of no significance here.

[2] Accord, as to federal savings and loan associations: *Washington Fed. S. & L. Assn.* v. *United States*, 304 F. Supp. 1072 (SD Fla. 1969), appeal pending in the United States Court of Appeals for the Fifth Circuit; *First Fed. S. & L. Assn.* v. *United States*, 288 F. Supp. 477 (WD Mo. 1968).

That application was granted and Lincoln has remained a member of the Bank since that time. The San Francisco Bank is one of 12 regional ones established and supervised by the Federal Home Loan Bank Board under the Federal Home Loan Bank Act of 1932, as amended, 12 U. S. C. §§ 1421–1449. These banks provide liquidity and funds for mortgage lending by making advances to member institutions as needed to meet unusual or heavy withdrawal and credit demands. Each member must purchase capital stock in its bank in an amount equal to 1% of its outstanding "aggregate unpaid loan principal" and to maintain that percentage. 12 U. S. C. § 1426 (c).

In June 1938 Lincoln became, and still is, an institution insured by the Federal Savings and Loan Insurance Corporation (FSLIC), a corporation created by § 402 of the National Housing Act, 12 U. S. C. § 1725, and under the direction of the Federal Home Loan Bank Board. By statute FSLIC has the duty to insure the accounts of all federal savings and loan associations; it also may insure the accounts of qualified state-chartered associations such as Lincoln. Section 403 (a); 12 U. S. C. § 1726 (a).

Each institution so insured was originally required, by § 404 (a) of the Act, 48 Stat. 1258–1259, to pay FSLIC an annual insurance premium measured by the total amount of its accounts plus creditor obligations.[3] The statute provided that these premiums were to continue annually until FSLIC's reserve for losses amounted to 5% of the insured accounts plus creditor obligations of all its insured institutions, and at such intervals thereafter as were necessary to maintain the reserve at that level.

This pattern was changed, however, effective January 1, 1962, by the Act of September 8, 1961, Pub. L. 87–210,

[3] For more than a decade before 1963 the annual premium was at the rate of 1/12 of 1% of that total, 64 Stat. 259; prior thereto the premium had been, successively, 1/4 and 1/8 of 1%. 48 Stat. 1258–1259; 49 Stat. 298.

75 Stat. 482. That Act, by its § 3, amended § 404 (a), 12 U. S. C. § 1727 (a), to its present form.[4]

Section 404 (a) now requires FSLIC to establish two reserves, namely, a Primary Reserve "which shall be the general reserve," and a Secondary Reserve. The requirement for the annual premium of ½ of 1% is continued, but the level of the general reserve was lowered from 5% to 2% of the total of accounts plus creditor obligations. Section 404 (b)(1) and 404 (b)(2); 12 U. S. C. §§ 1727 (b)(1) and 1727 (b)(2). The 1961 Act, moreover, added subsection (d) to § 404. 12 U. S. C. § 1727 (d). This required that the insured institution pay FSLIC, with respect to any calendar year, an "additional premium in the nature of a prepayment with respect to future premiums of such institution under subsection (b). . . ." This "additional premium" was, and still is, 2% of the net increase in the total of the institution's insured accounts, less any amount the institution is required, by 12 U. S. C. § 1426 (c), as of the end of that year, to expend in purchasing stock in the Federal Home Loan Bank.[5] The additional premium is to be

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[4] Section 404.

"(a) The Corporation shall establish a Primary Reserve which shall be the general reserve of the Corporation and a Secondary Reserve to which shall be credited the amounts of the prepayments made by insured institutions pursuant to subsection (d) and the credits made pursuant to the first sentence of subsection (e)."

[5] The 1961 Act, by its § 2, also amended § 6 of the Federal Home Loan Bank Act, 12 U. S. C. § 1426, to reduce from 2% to 1% the stock an insured institution is required to hold in relation to its outstanding unpaid loan principal. (The 2% requirement had been provided by the Act of June 27, 1950, c. 369, § 2, 64 Stat. 257.) It was contemplated that for most institutions this reduction would approximately offset the additional payment to the Secondary Reserve required under § 404 (d). H. Rep. No. 823, 87th Cong., 1st Sess., p. 2 (1961); S. Rep. No. 778, 87th Cong., 1st Sess., pp. 1-2 (1961).

credited to the Secondary Reserve. Section 404 (a); 12 U. S. C. § 1727 (a).

As noted, FSLIC's statutorily prescribed Primary Reserve is its general reserve. It is credited annually with the Corporation's net income; this net thus represents retained earnings. The § 404 (b)(1) premium payments, that is, the ½₂ of 1% required of each insured institution, constitute a major item in FSLIC's gross income. To the extent these premium payments exceed the corporation's expenses and insurance losses for the year, they flow as part of FSLIC's net to the Primary Reserve. The insured institutions have no property interest in the funds constituting the Primary Reserve.

The Secondary Reserve subsists separately and possesses different characteristics. It, of course, receives the 2% "additional premium," to the extent such is payable, required by § 404 (d) from each insured institution. FSLIC must also credit the Secondary Reserve annually with a "return" on the Secondary Reserve's "outstanding balances . . . at a rate equal to the average annual rate of return to the Corporation during the year . . . on the investments held by the Corporation in obligations of, or guaranteed as to principal and interest by, the United States." Sections 404 (a) and 404 (e); 12 U. S. C. §§ 1727 (a) and 1727 (e). In contrast with the Primary Reserve, the Secondary Reserve is "available . . . only for losses of the Corporation" and then "only to such extent as other accounts of the Corporation which are available therefor are insufficient for such losses." Section 404 (e); 12 U. S. C. § 1727 (e).

Each insured institution has a pro rata share in the Secondary Reserve. Section 404 (e) states that this is not assignable or transferable except as FSLIC, by regulation or otherwise, provides "in cases of merger or consolidation, transfer of bulk assets . . . and similar transactions . . . ." An insured institution may obtain a cash

refund of its pro rata share if its status as an insured is terminated, § 407; 12 U. S. C. § 1730, or if a receiver or other legal custodian is appointed for purposes of liquidation, or if the Corporation determines that the institution has gone into liquidation. Section 404 (f); 12 U. S. C. § 1727 (f).

Following any December 31 on which the aggregate of the Primary Reserve and the Secondary Reserve equals or exceeds 2% of the total of all insured accounts plus creditor obligations of all the insured institutions (and the Primary Reserve alone does not equal or exceed such 2%), the additional premiums required by § 404 (d) are suspended. Section 404 (g); 12 U. S. C. § 1727 (g).[6] When this takes place, the pro rata share of each insured institution in the Secondary Reserve is used, to the extent available, to discharge the institution's obligation to pay its regular, or basic, premium required for that year under § 401 (b)(1). Thereafter, if the aggregate of the two reserves decreases to less than 1¾%, the obligation to pay the additional premium under § 404 (d) resumes and the pro rata share in the Secondary Reserve is no longer used to pay the § 404 (b)(1) regular premium. Whenever, following any December 31, the Primary Reserve alone equals or exceeds such 2%, the Corporation shall pay in cash to each insured institution its pro rata share of the Secondary Reserve and shall not thereafter accept further § 404 (d) prepayments.[7]

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[6] The Act of December 23, 1969, Pub. L. 91-151, § 6 (a), 83 Stat. 375, changed, effective after 1969, the applicable reserve and premium measures to the designated percentages of only "accounts" rather than accounts plus "creditor obligations."

[7] In 1961 FSLIC projected that the aggregate of the Primary and Secondary Reserves would equal or exceed 2% of all accounts and creditor obligations of all insured institutions by 1970; that no payments to the Secondary Reserve would be required for 1971-1975 and 1980-1995; that the Primary Reserve alone would reach

FSLIC maintains a separate account for each insured institution's share of the Secondary Reserve. It submits to the institution annually a statement disclosing that share and the interest credited to it.[8] Under regulations issued by the California Savings and Loan Commissioner and by the Federal Home Loan Bank Board, Lincoln reports its interest in FSLIC's Secondary Reserve as an asset on its balance sheet and treats the interest earned on its pro rata share of the Secondary Reserve as income.[9]

FSLIC annually sends Lincoln an "Insurance Premium Notice" for the basic premium due under § 404 (b)(1). It also sends Lincoln annually a "Notice of Insurance Premium Prepayment" for the amount, if any, due under § 404 (d). For 1963 the former was $135,760.52 and the latter was $882,636.86. Each was paid by Lincoln.

On its 1963 federal income tax return Lincoln deducted both its § 404 (b)(1) payment and its § 404 (d) payment as ordinary and necessary business expenses under § 162 (a) of the Code. The Commissioner allowed the former, but disallowed the latter.

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the 2% level by 1995; and that the Secondary Reserve would be consumed by 1995 in discharging the insured institutions' premium obligations under § 404 (b)(1).

As a consequence of the 1969 amendments effected by Pub. L. 91-151, eliminating creditor obligations in measuring the adequacy of the reserves, the aggregate of FSLIC's Primary and Secondary Reserves reached the 2% suspension level in 1969 rather than 1970. Beginning in 1970 the Secondary Reserve is being used to fulfill the institutions' premium obligations under § 404 (b)(1).

[8] As of December 31, 1963, Lincoln's share amounted to $1,034,689.86. As of December 31, 1967, it was $4,922,115.46. This had been accumulated since the § 404 (d) and (e) payments and credits began as required by the 1961 Act.

[9] The Internal Revenue Service has ruled that, for a cash basis taxpayer, this interest is not taxable in the year earned, but only when it is utilized from the Secondary Reserve to pay the institution's § 404 (b)(1) premium or when it is otherwise made available to the institution. Rev. Rul. 66-49, 1966-1 CB 36, 38.

The Tax Court held that the § 404 (d) payment was a nondeductible capital expenditure and was not an ordinary and necessary business expense, and that the payment was deductible only when used from the Secondary Reserve to pay § 404 (b)(1) premiums or to meet actual losses of FSLIC. As noted above, the Ninth Circuit reversed by a divided panel.

II

To qualify as an allowable deduction under § 162 (a) of the 1954 Code, an item must (1) be "paid or incurred during the taxable year," (2) be for "carrying on any trade or business," (3) be an "expense," (4) be a "necessary" expense, and (5) be an "ordinary" expense. This Court has considered these several requirements, or one or more of them, in a number of cases. See, for example, *Welch* v. *Helvering*, 290 U. S. 111 (1933); *Helvering* v. *Winmill*, 305 U. S. 79 (1938); *Deputy* v. *du Pont*, 308 U. S. 488 (1940); *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590 (1943); *Commissioner* v. *Heininger*, 320 U. S. 467 (1943); *Commissioner* v. *Tellier*, 383 U. S. 687 (1966); *Woodward* v. *Commissioner*, 397 U. S. 572 (1970); *United States* v. *Hilton Hotels Corp.*, 397 U. S. 580 (1970).

In *Welch* Mr. Justice Cardozo emphasized the difference between the "ordinary" and the "necessary" and the need for satisfying both in order to achieve the deduction. It is in that case where his well-known, but elusive, suggestion for the answer appears:

> "The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle." 290 U. S., at 115.

In *du Pont* MR. JUSTICE DOUGLAS stressed, 308 U. S., at 493, 495–496, the accepted rule of the "popular or

received import" of a statute's words, and further emphasized that "Ordinary has the connotation of normal, usual, or customary," and that each case "turns on its special facts." In *Tellier* MR. JUSTICE STEWART also emphasized the double requirement of "ordinary" and "necessary" and said:

> "Our decisions have consistently construed the term 'necessary' as imposing only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business' . . . . The principal function of the term 'ordinary' in § 162 (a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset." 383 U. S., at 689–690.

So much for generalities. Here clearly, as to its § 404 (d) "additional premium" payment in 1963, Lincoln satisfied three of the five listed requirements. The payment was made during the taxable year. It was made in carrying on a trade or business. And it was a "necessary" payment, for it was compelled by the provisions of the National Housing Act. The Government so concedes. The focus, therefore, and our only concern here, is whether the payment was an expense and an ordinary one within the meaning of § 162 (a) of the Code.

Lincoln's argument essentially is that its § 404 (d) payment was really no different from its § 404 (b)(1) payment for both were premiums for insurance of its depositors' accounts and creditor obligations; that all similarly situated insured savings and loan associations (there were 4,419 at December 31, 1963) paid the § 404 (d) premium; and that the possibility of a future benefit from the expenditure does not serve to make it capital in nature as distinguished from an expense.

We feel that the very recital of the facts and of the structure and operation of FSLIC's Reserves, in Part II of this opinion, itself provides an answer adverse to Lincoln's argument. It is not enough, in order that an expenditure qualify as an income tax deduction, that it merely be one paid by all similarly insured associations, or that it serves to fortify FSLIC's insurance purpose and operation. Further, the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.

What is important and controlling, we feel, is that the § 404 (d) payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162 (a) in the absence of other factors not established here. We note the following:

A. The § 404 (d) payment to FSLIC, when made, is subject to positive and rigid continuing controls. The payment must flow into the Secondary Reserve. That reserve is primarily available only for stated and circumscribed purposes, namely, the payment of losses and then only to the extent all other assets of FSLIC are insufficient to cover those losses. The Secondary Reserve thus has complete seniority with respect to demands upon FSLIC. It is the asset last called upon.

B. The insured institution has a distinct and recognized property interest in the Secondary Reserve. This is revealed by: (1) The recognition, in § 404 (e), of transferability of the institution's pro rata share therein. This transferability is limited and restricted, to be sure, but it exists for approved situations of merger, consolidation, and the like. (2) The prospective refund, and in cash at that, of the institution's pro rata share upon

termination of its insured status, or upon receivership or liquidation, or when the Primary Reserve alone reaches the suspension level. (3) The use of the institution's pro rata share to pay its basic premium under § 404 (b)(1) when the suspension level is reached by the aggregate of the Primary and Secondary Reserves. (4) FSLIC's maintenance of a separate account for each insured institution's share in the Secondary Reserve. (5) The statutorily required annual credit from FSLIC's earnings to the institution's share of the Secondary Reserve. The share thus is an income-producing entity and the income inures for the benefit of the insured institution.

C. Although compulsory accounting rules do not control tax consequences, *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552, 562 (1932), there is significance in the fact that all concerned here have recognized the presence and the significance of this property interest in the Secondary Reserve. FSLIC submits annual statements to its insured institutions showing payments and credits to their respective shares. Lincoln, albeit by federal and state requirements, shows that interest as an asset on its balance sheet and the credit as income. And Lincoln's parent corporation, First Lincoln Financial Corporation, although not subject to such regulation, has done the same in its financial statements.

D. The nature of the adjustments effected by the 1961 Act is of some import. Due primarily to the rapid growth of insured institutions in the years preceding the passage of that Act, the ratio of FSLIC's reserves to potential liability had declined. S. Rep. No. 778, 87th Cong., 1st Sess., 2, 12; Hearings before Subcommittee on Banking and Currency on H. R. 7108 and H. R. 7109, 87th Cong., 1st Sess., p. 10. By the Act Congress reduced the requirement for Federal Home Loan Bank stock and at the same time channeled new funds to FSLIC's Sec-

ondary Reserve. The § 404 (d) payment and the reduction in the FHLB stock purchase requirement were effectuated together. Certainly the FHLB stock is an asset and its acquisition is capital in nature. The complementary § 404 (d) payment is directed to a fund. Each is a device designed to achieve a particular and common result, namely, the providing of protection to the insured institution and to its depositors by way, in the one case, of liquidity and availability of loan funds and, in the other, by way of segregated amounts available to offset possible losses. Each is more permanent than temporary. Each partakes more of the character of an asset than of an expense. And the two are made complementary by the very provisions of § 404 (d).

We do not regard as contrarily persuasive, or as imposing an expense characteristic on the § 404 (d) payments, six features emphasized by Lincoln or by the Court of Appeals:

A. The possibility that Lincoln's share of the Secondary Reserve would be consumed by FSLIC's losses and thus would never be refunded to Lincoln. The Tax Court pointed out, 51 T. C., at 97, that this hazard exists with any routine investment in a bank or an insurance company and yet its presence does not make that investment an expense rather than a capital undertaking.

B. The general unlikelihood, as a practical matter, of Lincoln's recovery of its pro rata share of the Secondary Reserve. It is suggested that liquidation will not take place because in this day corporate activity is assumed to be a continuing process and not limited in duration. It is further pointed out that termination of FSLIC insurance is a business impossibility for it would result in mass withdrawal of depositors' accounts and in institutional suicide. It may well be true that liquidation is unlikely and that termination of insurance would be an

undesirable business decision. The same may usually be said, however, of a manufacturing corporation's investment in plant and equipment or in patents or in many other assets basic to its business and function.

C. The claimed identity of purpose of the § 404 (b)(1) and § 404 (d) payments, namely, the providing of insurance for depositors' accounts. The former, however, is only annual in phase and operation. It provides insurance for the year. When the year passes, the insurance ceases. The latter, however, provides a fund available for losses not only in the current year, but in the future. It is a fund capable under certain circumstances of finding its way back to the coffers of the insured institutions. The ultimate purpose of the two payments may have much in common, but the route and the life of each differs from the other.

D. The compulsory character of the payment imposed both by the governing statute and the economic facts of life. Lincoln concedes, however, "Compulsion, whether legal or economic, should have no bearing upon the question whether a payment is an expense or a capital expenditure." [10]

E. The annual accounting concept of the income tax. This factor is relevant when the year of deduction is in issue. It has less consequence in the determination of whether an item is or is not an ordinary expense. As to this, the mere maturing of liability is not enough.

F. The suggestion that the § 404 (d) payment is not included in the list of nondeductible capital expenditures specified by § 263 of the 1954 Code. It is clear from the very language of §§ 162 (a) and 263 that the two sections together are not all inclusive, and that § 263 does not provide a complete list of nondeductible expenditures. *Iowa Southern Utilities Co.* v. *Commissioner*,

[10] Brief in Opposition, p. 17.

333 F. 2d 382, 385 (CA8 1964), cert. denied, 379 U. S. 946; *General Bancshares Corp.* v. *Commissioner*, 326 F. 2d 712, 716 (CA8 1964), cert. denied, 379 U. S. 832. See *Helvering* v. *Winmill*, 305 U. S. 79 (1938); *Woodward* v. *Commissioner*, 397 U. S. 572 (1970); *United States* v. *Hilton Hotels Corp.*, 397 U. S. 580 (1970).

III

Lincoln's pro rata share of the Secondary Reserve, of course, is not without its tax aspects. If its share is used to pay losses or if, when the suspension level is reached, it is devoted to the payment of Lincoln's § 404 (b)(1) premium, a deduction at that time for the amount so used would appear to be in order. Indeed, the Internal Revenue Service has so ruled. Rev Rul. 66–49, 1966–1 C. B. 36, 37. Cf. Treas. Regs. § 1.162–13.

We emphasize that just as compulsory accounting is not controlling tax-wise, *Old Colony Railroad Co.* v. *Commissioner*, *supra*, so the statutory labels of "prepayment" and "additional premium" contained in § 404 (d) are not controlling. *Burnett* v. *Commissioner*, 356 F. 2d 755, 758 (CA5 1966), cert. denied, 385 U. S. 832. We also emphasize that the fact that a payment is imposed compulsorily upon a taxpayer does not in and of itself make that payment an ordinary and necessary expense within the meaning of § 162 (a) of the 1954 Code.

We therefore conclude that Lincoln's § 404 (d) payment made in 1963 is not deductible under § 162 (a). See *Wichita State Bank & Trust Co.* v. *Commissioner*, 69 F. 2d 595, 596 (CA10 1934), cert. denied, 293 U. S. 562.

The judgment of the Court of Appeals is reversed.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 544.—October Term, 1970

Commissioner of Internal Revenue, Petitioner, *v.* Lincoln Savings and Loan Association.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[June 14, 1971]

Mr. Justice Douglas, dissenting.

Respondent is a state-chartered savings and loan institution, whose deposits are insured by the Federal Savings and Loan Insurance Corporation (FSLIC). To obtain this coverage, respondent must pay two premiums. Under § 404 (b) of the National Housing Act, it pays an annual premium of 1/12 of one percent of the total amount of its savings accounts and creditor obligations. Pursuant to § 404 (d), it must also pay an additional premium equal to two percent of any net increase in the total amount of its insured accounts.[1] The § 404 (b) premium is considered gross income of FSLIC, approximately 95% of which is transferred to its Primary Reserve, to cover losses. These premiums must be paid by insured institutions until the Primary Reserve equals two percent of the total insured savings accounts and creditor obligations of all insured institutions. Thereafter, insured institutions need pay no premiums unless and until the Primary Reserve drops below two percent. The § 404 (d) premium is not considered gross income of FSLIC but is transferred to a Secondary Reserve, to be used to cover losses only if other accounts prove insufficient, a possibility

[1] This amount may be reduced by an amount equal to any requirement for the purchase of stock in the Federal Home Loan Bank of which the insured is a member.

considered extremely remote. A separate accounting is kept for each insured institution, showing the § 404 (d) premiums paid. Under § 404 (g), at any time that the aggregate of the Primary and Secondary Reserves reaches two percent of all insured accounts and creditor obligations, no § 404 (d) payments need be made, and funds from the Secondary Reserve may be used to make § 404 (b) premium payments, until the aggregate falls below 1¾%. When the Primary Reserve reaches two percent, FSLIC is to pay each insured institution its pro rata share of the Secondary Reserve in cash. By FSLIC's projections, no § 404 (d) premium payments will be required in the years 1971 to 1975 and after 1979. No § 404 (b) premiums will be required after 1995, as the Primary Reserve will reach two percent. The respondent argues that there will be no payments of pro rata shares at that time, as the calculations of FSLIC show that the Secondary Fund will be exhausted prior to 1995.[2]

On its federal tax return for 1963 respondent deducted both its § 404 (b) and § 404 (d) premium payments as ordinary and necessary business expenses. The Commissioner of Internal Revenue allowed the deduction of § 404 (b) premiums, but disallowed the latter, characterizing these payments as nondeductible capital investments in FSLIC, to be deducted only when used to pay § 404 (b) premiums or when used to meet actual losses of FSLIC. The Tax Court affirmed this ruling. The Court of Appeals for the Ninth Circuit reversed the Tax Court, finding the § 404 (d) premiums to be a reasonable and necessary business expense, deductible in the year paid. I

[2] The Solicitor General argues that it is possible that some insured institutions might receive refunds from the Secondary Reserve, if their growth fits a certain pattern. This however only raises the possibility of such a return, without showing that such a possibility is more than remote.

agree with the Court of Appeals and dissent from the decision here.

There is no claim that the § 404 (d) premiums are not necessary. The position of the United States is that these premiums are not "ordinary," but "in the nature of capital expenditures which, if deductible at all, must be amortized over the useful life of the asset." *Commissioner* v. *Tellier*, 383 U. S. 687, 689–690 (1966). The government relies on the principle that a cost which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year is a capital outlay. From this it argues that the determination of whether respondent's § 404 (d) premiums are capital expenditures or deductible business expenses depends on whether the payments will provide a benefit in future years.

Because the respondent will obtain a benefit in the future from these premiums, in the form of lower § 404 (b) premiums or by a full refund of its pro rata share on termination or liquidation, he argues, the Secondary Reserve is a capital asset. It is not used for losses, and will never be used except in the event of a national catastrophe. These premiums are not recurring, and will likely be paid only in 13 of the 34 years from 1962 to 1995. Accounting principles, he claims, demand that these payments be deducted when they are used, either to pay § 404 (b) premiums or to pay losses. "Only in this manner will the costs of FSLIC insurance be matched against the revenues generated because such insurance is maintained."

The rule professed by the United States is, of course, sound. The error is in applying it to this case. Respondent has not established an asset for future benefit. It has merely paid the premiums necessary to obtain insurance. It is true that premiums paid in 1963 may result

in a reduction in premiums in later years. But labelling this the creation of an asset proves too much, for it invalidates the deduction of § 404 (b) premiums as well.

The benefit to be obtained from the payment of § 404 (d) premiums, whether they be capital expenditures or deductible expenses, is not the reduction of future premiums but insurance coverage. The government readily admits that the present level of § 404 (b) premiums is not needed to cover current foreseeable losses. Indeed, losses have never exceeded investment income. The high premium rate is for the purpose of establishing a Primary Reserve, to cover conceivably serious losses in the future. When the Primary Reserve reaches a level deemed sufficient, no premium payments will be required at all. If "the costs of FSLIC insurance [are to] be matched against the revenues generated because such insurance is maintained," a major portion of the § 404 (b) premiums should also be capitalized, to be depreciated over some appropriate term.

Nor is it controlling that the Secondary Reserve is a capital account insofar as FSLIC is concerned. As the Court of Appeals stated

> "We think the emphasis upon the treatment of the receipt by the payee, FSLIC, is mistaken and that in determining whether an expense is an ordinary and necessary expense of doing business, the focus should be on the taxpayer and the taxpayer's business, not on what the payee does with the money paid. This is not to say that rights retained by the taxpayer are to be ignored." 422 F. 2d 90, 92.

A decision that § 404 (d) premiums are not deductible, while § 404 (b) premiums are, must rest on the only distinction between the two, the rights retained by respondent in the Secondary Reserve. These are evidenced by the keeping of separate "accounts," the payment of earn-

ings to these accounts, and the possibility of a recovery of a pro rata share of the Reserve. But, as the Court of Appeals noted, respondent is a going concern, and the possibility of a return of its share on liquidation is not a proper consideration. As termination of insurance would surely lead to liquidation, this could not be considered either. The possibility that some part of the Secondary Reserve might be returned to respondent when the Primary Reserve reaches a sufficient level is, at best, remote. This contingent possibility of recovery does not render an otherwise deductible payment nondeductible. Alleghany Corporation, 28 T. C. 298, 305; Electric Tachometer Corp., 37 T. C. 158, 161.

The returns paid on a pro rata share of the Secondary Reserve are paid out of earnings, that is, out of funds which would otherwise be transferred to the Primary Reserve. The payment does not increase the aggregate amount of the reserves. The returns paid are not available to the insured institution, and not taxable to it until paid for its benefit, according to the Internal Revenue Service. At that point, the insured institution would declare the income and deduct the amount as an expense. Therefore, absent the remote possibility that the insured institution might receive a pro rata share, it is immaterial whether returns are paid to the Secondary Reserve or only to the Primary Reserve. Also, the revenue ruling that the insured institution does not have even constructive possession of a pro rata share of the Secondary Reserve, for purposes of taxing returns on that fund, is inconsistent with the position that the same pro rata share is a capital asset of the institution.

On these facts, the Court of Appeals was correct in determining that the § 404 (d) premiums, paid for the purpose of obtaining insurance necessary for the success of respondent's business, were deductible as an ordinary business expense.